

TAX REFORM PROPOSALS—VII

HEARING
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
NINETY-NINTH CONGRESS
FIRST SESSION

JUNE 20, 1985
(Capital Formation)



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON : 1986

51-220 O

5361-22

COMMITTEE ON FINANCE

BOB PACKWOOD, Oregon, *Chairman*

ROBERT J. DOLE, Kansas

WILLIAM V. ROTH, Jr., Delaware

JOHN C. DANFORTH, Missouri

JOHN H. CHAFEE, Rhode Island

JOHN HEINZ, Pennsylvania

MALCOLM WALLOP, Wyoming

DAVID DURENBERGER, Minnesota

WILLIAM L. ARMSTRONG, Colorado

STEVEN D. SYMMS, Idaho

CHARLES E. GRASSLEY, Iowa

RUSSELL B. LONG, Louisiana

LLOYD BENTSEN, Texas

SPARK M. MATSUNAGA, Hawaii

DANIEL PATRICK MOYNIHAN, New York

MAX BAUCUS, Montana

DAVID L. BOREN, Oklahoma

BILL BRADLEY, New Jersey

GEORGE J. MITCHELL, Maine

DAVID PRYOR, Arkansas

WILLIAM DIEFENDERFER, *Chief of Staff*

MICHAEL STERN, *Minority Staff Director*

CONTENTS

PUBLIC WITNESSES

	Page
American Council For Capital Formation, Dr. Charls E. Walker, chairman	94
Auerbach, Alan J., Dr., professor of economics, University of Pennsylvania	2
Christian, Ernest S., Jr., of Patton, Boggs & Blow	38
Cohn, Herbert B., chairman, Committee For Capital Formation Through Divi- dend Reinvestment	152
Committee For Capital Formation Through Dividend Reinvestment, Herbert B. Cohn, chairman	152
Fullerton, Dr. Don, associate professor, Economics, University of Virginia	27
Goodyear Tire & Rubber Co., Robert E. Mercer, chairman and chief executive officer	120
Laurence H. Meyer & Associates, Dr. Joel Prakken, vice president	13
Mercer, Robert E., chairman and chief executive officer, Goodyear Tire & Rubber Co.	120
O'Brien, Edward I., president, Securities Industry Association	129
Patton, Boggs & Blow, Ernest S. Christian, Jr.	38
Prakken, Dr. Joel, vice president, Laurence H. Meyer & Associates, Ltd.	13
Securities Industry Association, Edward L. O'Brien, president	129
Walker, Dr. Charls E., chairman, American Council For Capital Formation	94

ADDITIONAL INFORMATION

Committee press release	1
Prepared statement of Dr. Alan J. Auerbach	5
Prepared statement of Dr. Joel L. Prakken	15
Prepared statement of Dr. Don Fullerton	29
Prepared statement of Ernest S. Christian, Jr.	40
Prepared statement of Dr. Charls E. Walker	96
Prepared statement of Robert E. Mercer	122
Prepared statement of the Financial Analysts Federation	177
Prepared statement of Herbert B. Cohn	154

COMMUNICATIONS

Institute for Research on the Economics of Taxation	184
Investment Company Institute	201
Machinery and Allied Products Institutes	226
Machinery Dealers National Association	248
National Association of Small Business Investment Companies	257
Stockholders of America, Inc.	264

TAX REFORM PROPOSALS—VII

THURSDAY, JUNE 20, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:31 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Roth, Chafee, Heinz, Grassley, Bentsen, Baucus, and Bradley.

[The press release announcing the hearing follows:]

[Press Release No. 85-040, June 11, 1985]

CHAIRMAN PACKWOOD ANNOUNCES FINANCE TAX REFORM HEARINGS

Senator Bob Packwood (R-Oregon), Chairman of the Committee on Finance, today announced further Committee hearings in June on President Reagan's tax reform proposal.

Chairman Packwood announced the second five days of hearings, as follows:

On Wednesday, June 19, 1985, the Committee will receive testimony from witnesses representing taxpayer organizations and public interest groups.

The Committee will hear from public witnesses on the impact of the tax reform proposal on capital formation on Thursday, June 20, 1985.

On Tuesday, June 25, 1985, invited witnesses will discuss the issue of whether the tax-exempt use of industrial development bonds ought to continue.

On Wednesday, June 26, 1985, public witnesses will testify on research and development tax credits, and venture capital formation.

The Committee will receive testimony from economists on the impact of the President's tax reform proposal on the economy on Thursday, June 27, 1985.

All hearings will begin at 9:30 a.m. and will be held in Room SD-215 of the Dirksen Senate Office Building.

The CHAIRMAN. The committee will come to order, please. This is one more in a series of continuing meetings on the generic subject of the President's tax reform bill, but, obviously, we are hearing testimony on all aspects of taxation. For those who haven't heard what I have indicated previously about timing, we will continue these hearings through June, through July, not in August, through September, and then we will see at what stage a bill appears to be—and in the House. I am working on the assumption that if the House can get a bill to the Senate by the 15th of October, that we would be done with our hearings at that time, except for what additional hearings we might have to have because the House had so changed some provisions of the bill that we, in good conscience, simply hadn't had hearings on the subject as changed. We might have, therefore, a week of hearings after that and a markup—I don't know how long the markup would take—we would hope to be on the floor of the Senate—oh, I don't know—sometime between

the 20th of November and the 1st of December. I don't know how long it will be on the Senate floor, but if everything went as rapidly as possible, we could finish the tax bill by Christmas, but it does depend upon our getting a bill by October 15. And it does assume that everything in the Senate moves as rapidly as it can move in a system that is deliberately designed for delay. And I don't say that with criticism. On balance, we have made more mistakes in haste in the past than we have lost opportunities in delay. And if somebody really wants to hold us up or filibuster or has several thousand amendments, then they could throw that timetable off. Today, we are hearing testimony on the effects on capital formation of the bill as proposed by the President and as being considered by the House, and we have a panel. Our first panel is Dr. Alan Auerbach, professor of economics at the University of Pennsylvania; Dr. Joel Prakken, the vice president of Laurence H. Meyer & Associates of St. Louis; Dr. Don Fullerton, associate professor of economics at the University of Virginia and a visiting scholar at the American Enterprise Institute, and Ernest Christian of Patton, Boggs & Blow, a well-known tax practitioner in the area around Washington, DC, and well known to us on the Hill. Gentlemen, if you want to come up. I might say that Professor Fullerton is the brother of Larry Fullerton, who used to work for me for several years on the Commerce Committee. Unless you have any objections or have worked it out otherwise yourselves, we will take you in the order that you appear on the witness list, and we will start with Dr. Auerbach first. You were all very good in getting your statements in, and I was able to read them last night and this morning. They will be in the record in full, and we ask that you abbreviate your statements. Dr. Auerbach, go right ahead.

STATEMENT OF DR. ALAN J. AUERBACH, PROFESSOR OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA

Dr. AUERBACH. Thank you very much, Mr. Chairman. I am pleased to be here to give my views of what the President's recently announced tax program will do for capital formation. Let me say at the outset that, in many respects, the program would constitute an improvement over current law. Likewise, it overcomes certain of the difficulties present in the Treasury's original proposal, and therefore, it represents a reasonable compromise between the objectives of that proposal and those that underlie present tax policy. At the same time, I am troubled by certain changes that have been made in the transition from the November proposal to the new one and would urge you to consider these carefully before accepting the package in its entirety. My most serious concern is with the question of revenue neutrality. The critical problem facing U.S. capital formation today and in the coming years is the rapid growth of the national debt that began a few years ago and continues. This absorption of a large fraction of national saving by the Government means that domestic investment must either give way or be maintained by funds from abroad. In the latter case, the resulting capital inflow as has occurred and its associated strengthening of the dollar is bad news for businesses attempting to sell abroad or meet foreign competition at home. I think that is quite evident. This

problem will not improve without attention to the deficit. The solution does not lie in the enactment of protectionist legislation. Simple arithmetic suggests that an improvement of the current account must bring with it a decline in the capital account surplus that has, until now, prevented the collapse of domestic investment. Without an implausibly large increase in domestic savings, exports and investment cannot be simultaneously supported by a policy that does not reduce the deficit. I voice this concern because, in my view, the President's Tax Program would constitute a tax cut. My conclusion rests on a number of facts. First, the program as presented would result in small revenue reductions in later fiscal years. Second, there are various places where, with no apparent explanation, the new proposal is forecast to raise more revenue than the November proposal would have. Whether such increases are due solely to changes in economic assumptions or in addition to the complex interaction of subtle provisions cannot be discerned from the data supplied. But given the experience of 1981, independent congressional revenue estimates for the new proposal should be carefully examined. Beyond these issues of revenue measurement, however, I think are more fundamental ones. In the long run, the program would lose revenue. It is predicted to lower individual tax payments by 7 percent and raise corporate tax payments by 9 percent. At 1986 budget levels, this would be a tax cut of about \$18 billion annually and higher at later budget levels. Even in the short run, the proposal has incorporated various changes from Treasury I that really have very little justification except for the need for revenue. The proposed repeal of income averaging, a year's delay in the provision for the indexation of inventories, and elimination of the gradual 1986 phaseout of State and local tax deductibility, for example. These changes are selective tax increases that have little to do with tax reform and don't seem especially fair economically justifiable. But they are dwarfed in magnitude by the proposed windfall tax on excess depreciation, which would raise \$58 billion during its application over the next few fiscal years. As this is a rather unorthodox measure, I will comment not only on its incentive effects but also its logical foundation. Although it is unusual for tax law changes to affect investment incentives retroactively in so direct a manner as this would, there is nothing novel about a tax policy influencing the profitability of previous investment. Whenever the corporate tax rate is reduced, previous investments become more profitable after tax. Whenever new investments receive substantial tax incentives not provided before, this may increase investment and drive down the profitability of assets in place. So, it is hard to rule out this proposed measure on grounds of fairness. Given this decision to tax windfalls accruing to previous investments, as I detail in my testimony, I find no compelling logic to support the particular path taken by this proposal. But whatever its logical inconsistency, it is a pretty good way to raise revenue in a nondistortionary manner. Taxing assets in place does very little to the incentive to invest because, as the proposal's general explanation says, the recapture rule applies only to old capital and thus has no effect on the cost of capital for new investment. One should add the caveat that new investment may be influenced as well, if investors view this policy as marking the dawn of a new

era of creative retroactive taxation. So, I think it is important that a distinction be drawn when adopting such a policy between taking back gains not anticipated by earlier legislation and simply increasing taxes after the fact. Now, let me turn to the most important issue—the impact of the President's proposal on the taxation of new investments. For depreciable assets, the present combination of the investment tax credit and ACRS depreciation allowances would be replaced by a new system which would maintain the simplicity of a small number of capital recovery classes and provide for the indexation of deductions to changes in the price levels. Taken alone, these provisions would lead to an increased incentive to invest overall and a better allocation of investment funds among different types of capital assets.

The CHAIRMAN. Dr. Auerbach, I am going to have to ask you to conclude. Let me tell you what we are up against. We have had requests for about 700 witnesses to testify. We can't fit them all in, and rather than letting witnesses go on as long as they wanted in the past, we are trying to hold them to 5 minutes to give us time for questions. And I had a chance to read your statement—and it is a good statement—but I am just going to have to stick pretty close to that rule, or we will be hearing this bill next June, July, and August 1986.

Dr. AUERBACH. May I have a minute to conclude, then?

The CHAIRMAN. Yes.

Dr. AUERBACH. Thank you. I wanted to point out that the fact that corporate revenues would rise between 1986 and 1990 does not contradict my conclusion in any respect that the incentive to invest would be improved. There are primarily three factors, detailed in my testimony, to explain the apparent discrepancies. One is the fact that the new system would provide for indexed depreciation allowances that would provide a much greater fraction of their value in the years after 1990, for which revenue estimates are not provided. Second, a number of the provisions which would raise corporate tax revenues include both the windfall which should not have an effect on investment incentives and also a number of measures such as the tightening up of bad debt reserves deductions, and property and casualty reserve deductions, which should not be seen as primarily affecting the incentive to invest. I will conclude with that.

The CHAIRMAN. Thank you. Next, we will take Dr. Prakken.
[The prepared written statement of Dr. Auerbach follows:]

Testimony before the Committee on Finance, U.S. Senate

by

Alan J. Auerbach

Professor of Economics, University of Pennsylvania and
Research Associate, National Bureau of Economic Research

June 20, 1985

Mr. Chairman and Members of the Committee:

I am pleased to be here to give my views of what the president's recently announced tax program will do for capital formation. Let me say at the outset that, in many respects, the program would constitute an improvement in this area over current law. Likewise, it overcomes certain of the difficulties present in the Treasury's original proposal of November 1984, and therefore represents a reasonable compromise between the objectives of that proposal and those that underlie present tax policy.

At the same time, I am troubled by certain changes that have been made in the transition from the November proposal to the new one, and would urge you to consider these carefully before accepting the package in its entirety.

Revenue Neutrality and the Deficit

I will begin with my most serious concern. A critical problem facing U.S. capital formation today and

in the coming years is the rapid growth of the national debt that began in 1981 and continues unabated. The absorption of a large fraction of national saving by the government means that domestic investment must either give way or be maintained by funds from abroad. In the latter case, the resulting capital inflow and its associated strengthening of the dollar is bad news for businesses attempting to sell abroad or meet foreign competition at home.

This problem will not improve without attention to the deficit. The solution does not lie in the enactment of protectionist legislation. Simple arithmetic suggests that an improvement of the current account must bring with it a decline in the capital account surplus that has until now prevented the collapse of domestic investment. Without an implausibly large increase in domestic saving, exports and investment cannot be simultaneously supported by a policy that does not reduce the deficit.

I voice this concern because, despite confusing language to the contrary, the president's tax program would constitute a tax cut. My conclusion rests on a number of facts. First, the program as presented would result in small revenue reductions in fiscal years 1988 and 1989. Second, there are various places where, with no apparent explanation, the new proposal is forecast to raise more revenue than the November proposal would have. For example, during fiscal years 1986-90, removal of the investment tax credit is projected to save \$19 billion more now than was anticipated under Treasury 1. Whether this increase is due solely to changes in economic assumptions or, in addition, to the complex interaction of subtle provisions cannot be discerned from the data supplied. Given the experience of 1981, independent Congressional revenue estimates for the new proposal should be carefully examined.

Beyond these issues of revenue measurement, however, are more fundamental ones. In the long run, the program would lose revenue. It is predicted to lower individual tax payments by 7 percent and raise corporate tax payments by 9 percent. At 1986 budget levels, this would be a tax cut of about \$18 billion dollars annually.

In the short run, the proposal has incorporated various changes from Treasury 1 that have little justification except for the need for revenue. The proposed repeal of income averaging raises \$16 billion dollars over the next five years. A year's delay in the provision allowing for the indexation of inventories raises perhaps \$5 billion, and elimination of the gradual 1986 phase-out of state and local tax deductibility raises \$17 billion. These changes have little to do with tax reform; they are selective tax increases that do not seem especially fair or economically justifiable. But they are dwarfed in magnitude by the proposed windfall tax on excess depreciation, which would raise \$58 billion dollars during its application.

Taxing Investment Incentives Retroactively

Along with the removal of most of the deduction for dividends paid, this represents the primary revenue increase from Treasury's original proposal in the area of business taxation. As this is a rather unorthodox measure, I will comment not only on its incentive effects, but also its logical foundation.

Although it is unusual for tax law changes to affect investment incentives retroactively in so direct a manner, there is nothing novel about a tax policy influencing the profitability of previous investments. Whenever the corporate income tax rate is reduced, previous

investments become more profitable after tax. Whenever new investments receive substantial tax incentives not provided before, this may increase investment and drive down the profitability of assets already in place. Thus, it is hard to rule out this proposed measure on grounds of fairness.

Given the decision to tax "windfalls" accruing to previous investments, however, I can find no compelling logic to support the particular path taken by this proposal. As described in the general explanation, it would, in a rough and ready manner, eliminate the gain from tax rate reduction accruing to investors in ACRS property who realize income at a tax rate of 33% (or 35%, for individuals) that was deferred through the use of accelerated depreciation when the tax rate was 46% (or 50%).

Beyond the potential inaccuracy of the approximation used, taking 40% of the excess of earnings and profits basis over ACRS basis into income over a three year period, I find this policy illogical. Since all investments, not just those in depreciable property, would gain from a tax rate reduction, why attack only that part of the tax base that is attributable to the previous acceleration of depreciation allowances?

Some might respond that the tax rate reduction is a quid pro quo for getting rid of ACRS, so that investors should not be allowed the advantages of both, but this would lead one to tax not the full deferral benefit of ACRS, just that part in excess of the very generous benefits that would remain under the proposed Capital Cost Recovery System (CCRS). For some investments, this excess would be negative.

Whatever its logical inconsistency, however, this is a pretty good way to raise revenue in a nondistortionary manner. Taxing assets in place does very little to the incentive to invest because, as the proposal's general

explanation says on page 196, "the recapture rule applies only to old capital and thus has no effect on the cost of capital for new equipment." One should add the caveat that new investment may be influenced as well if investors view this policy as marking the dawn of a new era of creative retroactive taxation. It is important, therefore, that a distinction be drawn when adopting such a policy between taking back gains not anticipated by earlier legislation and simply increasing taxes after the fact.

Incentives for New Investment

Let me turn now to the impact of the president's proposal on the taxation of new investment. For depreciable assets, the present combination of the investment tax credit and ACRS depreciation allowances would be replaced by a new system of depreciation schedules, the Capital Cost Recovery System. CCRS would maintain the simplicity of a small number of capital recovery classes, and would provide for the indexation of deductions to changes in the price level. Overall, the effective corporate tax rate on depreciable assets would be reduced to a small extent, with equipment facing a higher tax rate and structures facing a lower tax rate than under present law. Given the lower corporate tax rate and the provision for indexed FIFO accounting, inventory investment would also face a lower tax rate.

Taken alone, these provisions would lead to an increased incentive to invest, overall, and a better allocation of investment funds among different types of capital assets. Additional provisions complicate the picture somewhat, however. The lower marginal tax rate at which interest payments could be deducted would reduce the incentive for debt-financed investment, while the 10% dividends-paid deduction would, to some extent, reduce the cost of equity capital. The impact of these provisions would

vary across investments, depending on the method of finance, but I do not see these factors as affecting the general conclusion that the plan would be good for the level and allocation of investment.

The fact that corporate revenues would rise between 1986 and 1990 does not contradict this finding in any respect. There are primarily three factors that explain the apparent discrepancy between tax collections and the incentive to invest. First, the windfall tax on excess depreciation, while raising tax collections, should have a minimal impact on the incentive to invest in new capital. Second, many of the other provisions that would increase corporate taxes are not particularly associated with investment decisions. These include reform of the treatment of multiperiod production, limitations on reserve deductions for banks and insurance companies, and changes in the treatment of foreign source income. Finally, the timing of depreciation deductions under the new tax system is such that, compared to those of the current system, a greater percentage of their value is received by investors several years after making investments. Hence, the full incentives provided by the new provisions are not reflected by revenue projections extending only through 1990.

The first two of these points may be illustrated by examining corporate tax revenues projected for 1990, after the windfall tax is to be phased out. Excluding revenue increases that fall under the categories of Income Measurement, Financial Institutions and International Issues, corporate tax revenues would actually decrease by \$1.8 billion in that year. The final point follows from the fact that, in the long run, corporate tax revenues are projected to increase by only 9%, far less than the 23% projected for 1990. Thus, the corporate tax provisions directly affecting investment will bear even less heavily than is indicated by the calculation for 1990.

Capital Gains and Risk-Taking

As with interest payments, the original Treasury proposal's plan to index capital gains has been scrapped, except for gains on depreciable property. Taxing half of unadjusted gains would not reduce the tax burden relative to the original plan to tax indexed gains fully. This is borne out by a comparison of the revenue estimates for the two proposals. Hence, it is hard to justify this retrogression on the grounds that it would be good for capital formation.

To my knowledge, a major justification for this change is that it would be preferred for high-risk investments that have very high gains, if successful. These would benefit more from exclusion of gains than from the indexation of basis. But the real problem to be dealt with here is not one of capital gains, but capital losses. These investments yield such high returns, when successful, because they are frequently not successful, and investors must be compensated for taking the risk. With the limited deductibility of capital losses, maintained under the new proposal, an unfair asymmetry of tax treatment is imposed. Were losses fully deductible, no special treatment of gains would be necessary or appropriate.

The problem in implementing a policy of more complete deduction for capital losses is that, with a system of taxation upon elective realization, losses could be realized without limit and gains could be held indefinitely. But various solutions exist. The Kemp-Kasten proposal, for example, would have allowed full loss deductibility and included such amounts in the minimum tax base. Without resort to the minimum tax, one could allow a deduction of losses to the extent of unrealized gains, with a

corresponding step-up in basis for those gains.

Unfortunately, the only capital gains provision that has survived from the Kemp-Kasten bill is one that would allow taxpayers to elect annually, after 1990, whether to receive the 50% exclusion or an indexed basis for realized gains. This is an ill-conceived incentive for tax avoidance that would reduce revenue, and should be deleted from the proposal.

Conclusions

Relative to the original Treasury plan and, in the aggregate, relative to current law, the tax incentives incorporated in the president's tax proposals would present a favorable climate for business investment. But these incentives are not magically costless. Relative to Treasury 1, they represent by far the biggest reduction in revenue over the next five years of any of the changes made. Under the plan, part of this generosity would be recouped through the tax on "depreciation windfalls," part through various provisions not necessarily consistent with the aims of tax reform, perhaps some through changes in economic forecasts, and some not at all.

Once realistic phase-in schemes for some of the more severe reductions in tax preferences are countenanced, the tax reduction embodied in this plan will be larger. If the capital formation incentives it provides are to be effective, this aspect of the plan is unacceptable.

The gains to be anticipated from additional investment incentives are not negligible, but one should not expect too much. There is a view held by many that the current problem facing U.S. firms in their economic battle with foreign counterparts, notably in Japan, is the relatively

heavy burden of capital taxation in the U.S. I am aware of no evidence in support of this proposition. Nor is there convincing evidence that other factors give Japanese firms a lower cost of capital. A recent comparison of large Japanese and American firms I have completed with my colleague Albert Ando at the University of Pennsylvania failed to provide any support for the proposition of a systematically lower cost of capital in Japan.

Fixed investment in the U.S. now faces an effective tax rate that is very low by postwar standards. Its priority in the tax reform process, when difficult choices remain to be made, should be evaluated in this light.

**STATEMENT OF DR. JOEL PRAKKEN, VICE PRESIDENT,
LAURENCE H. MEYER & ASSOCIATES, LTD., ST. LOUIS, MO**

Dr. PRAKKEN. Thank you. Mr. Chairman and members of the committee, I am honored with the opportunity to address this distinguished group on the important subject of capital formation in tax reform. My remarks today are based on a study of the President's tax proposal, implications for capital formation, that was offered by myself and two colleagues and released last week in St. Louis by the Center for the Study of American Business. Our study was prepared using the Washington University economic model of the U.S. economy and indicates that the initial effect of the President's reforms would be to regard the gross national product, raise the unemployment rate, depress the value of the corporate equity and real estate, and widen the Federal deficit. Because the reforms would initially raise the costs of all forms of fixed capital considered, the consequent slowdown would be concentrated in the investment sector of the economy. As a result, stocks and capital generally would be depressed, not only initially, but even after 5 years. The stock of business equipment, which is closely linked to our overall productive capacity, would be most adversely affected. To give you an idea of the magnitude of some of the items we are discussing here, 1 year following implementation of the plan, real GNP would be about 1.6 percent lower than without reform. Business spending on equipment will be down by 4 percent, while outlays on business structures—and here I am defining structures as they are defined in the national accounts—would be off by about 2.5 percent. Housing starts will have fallen by about 14 percent, and residential investment measured in 1972 dollars by 13 percent. The unemployment rate would be 8-tenths of a point higher, and inflation would be more moderate. After 5 years, real GNP would nearly regain its original path as falling interest rates, in response to the initially weaker economy, help offset the initial increases in the cost of capital. However, while investment in both business and residential structures would actually be 2 percent higher, spending on business equipment would still be nearly 4 percent lower than

without reform. Furthermore, since over much of the period investment flows generally would be depressed, all stocks and fixed capital would be reduced after 5 years. The largest decline would occur for the stock of business equipment, which would be down by a little over 3 percent. The stock of single-family homes would be lower by about 7-tenths of a percent, and the stock of multifamily homes by about 1.3 percent. In terms of the business fixed investment, which I think is the crucial stock that most of us are concerned about, the real bugaboo here is the investment tax credit which has a significant impact in increasing the cost of capital. And although there are some other provisions of the proposed reform which are advantageous, they are not sufficient to offset the negative impact of the rescission of the ITC. I should say that these conclusions, like others based on statistical models of the macroeconomy, do not explicitly account for the economic gains that may occur if reform encourages a more efficient and hence more productive allocation of resources. These efficiency gains are likely to occur although it is difficult to estimate either the magnitude or the timing of their impact. Hence, it is sensible to view the deleterious effects that I am reporting here as defining the minimum efficiency gains that would be required to render the overall impact of the reform to be a positive one. Thank you.

The CHAIRMAN. Thank you very much. Professor Fullerton?
[The prepared written statement of Dr. Prakken follows:]

**THE PRESIDENT'S TAX PROPOSAL:
IMPLICATIONS FOR CAPITAL FORMATION**

Testimony

of

**Dr. Joel L. Prakken, Vice President
Laurence H. Meyer & Associates, L.t.d.
St. Louis, Missouri**

before the

**Finance Committee
of the United States Senate**

**Washington, D.C.
June 20, 1985**

Introductory Remarks

Mr. Chairman and members of the committee, I am honored with the opportunity to address this distinguished group on the important subject of capital formation and tax reform. My remarks today are based on a study, "The President's Tax Proposal: Implications for Capital Formation", authored by myself and two colleagues and released last week by the Center for the Study of American Business at Washington University in Saint Louis.

Summary of Findings

Our study, prepared using the Washington University Economic Model of the United States Economy, indicates that the initial effect of the President's reforms would be to retard the Gross National Product, raise the unemployment rate, depress the value of both corporate equity and real estate, and widen the federal deficit.

Because the reforms would initially raise the cost of all forms of fixed capital considered, the consequent slowdown would be concentrated in the investment sector of the economy. As a result, stocks of capital generally would be depressed not only initially, but even after five years. The stock of business equipment, which is closely linked to our overall productive capacity, would be most adversely effected.

Table 1 summarizes our estimates of the impacts of the reforms on the economy in general and on investment flows in particular. One year following implementation of the plan, real GNP would be 1.6% lower than without reform. Business

spending on equipment would be down by 4.1%, while outlays on business structures (as defined in the National Income and Product Accounts) would be off by 2.5%. Housing starts would have fallen 14.3% and residential investment, measured in 1972 dollars, by 12.7%. The unemployment rate would be 0.8 percentage points higher and inflation would be more moderate.

After five years, real GNP would nearly regain its original path as falling interest rates, in response to the initially weaker economy, helped offset the initial increases in the cost of capital. (See Table 2.) However, while investment in both business and residential structures would actually be 2% higher, spending on business equipment would still be 3.3% lower than without reform. Furthermore, since over much of the period investment flows generally would be depressed, all stocks of fixed capital would be reduced after five years. (See Table 3.) The largest decline would occur for the stock of business equipment, which would be down by 3.1%. The stock of single family homes would be lower by 0.7%; the stock of multi family homes by 1.3%.

These conclusions, like others based on statistical models of the macroeconomy, do not explicitly account for the economic gains that may occur if reform encourages a more efficient and hence more productive allocation of resources. These "efficiency gains" are likely to occur, although it is difficult to estimate either magnitude or the timing of their impact. Hence it is sensible to view the deleterious effects reported here as defining the minimum efficiency gains required to render the overall impact reform positive.

Impacts on the Cost of Capital

The "cost of capital" measures the cost of owning, operating and maintaining a piece of capital, allowing for the real purchase price of the good, the rate of depreciation in its real value (economic depreciation), the associated real financing costs, the relevant corporate and personal tax rates, and related tax considerations including rules governing depreciation allowances for tax purposes (tax depreciation), investment tax credits, and the treatment both of interest expenses and of capital gains income. Since the cost of capital reflects the true economic cost of investment in a capital good, an increase in the cost of capital discourages capital formation.

Table 4 reports the initial increases in the cost of capital that would occur if the President's reforms were implemented at *current* levels of interest rates, inflation and relative prices. Such "static" changes in capital costs have been calculated for the six different classes of investment goods: consumers durables, single-family homes, multi-family homes, producers equipment, nonresidential structures, and business inventories. The top portion of the table shows the rental prices under the current and proposed codes, while the bottom portion decomposes the overall percentage change into changes attributable to specific provisions of *Treasury II*.

As an example, under the current code the cost of capital for consumers durables is 22.47% per annum. Under the proposed code, it would initially rise to 22.89%, or an increase of 1.87%. The entire percentage rise is attributable to the 19% decline in marginal personal tax rates which, for given nominal interest rates, raises the after-tax cost of financing the durable. Other tax considerations are assumed to have no impact on the cost of consumers durables.

The case of single family housing is of more interest. Under *Treasury II*, the cost of capital for single-family units would rise 10%, from 18% per year to 19.8%. About half the increase occurs as the reduction in personal tax rates raises after-tax mortgage expenses. The other half is attributable to the loss of the deduction for state and local property taxes. Home ownership would, therefore, become significantly less attractive in the short run.

For multi-family units the analysis is more complicated since such buildings generally are renter-occupied and hence subject to different rules of taxation than owner-occupied single-family homes. The analysis assumes that because most multi-family structures are built and managed by sole proprietors, changes in personal tax rates (rather than corporate) remain relevant in calculating the rental price. However, renter-occupied units yield an income stream that is taxable, while the imputed stream of income enjoyed by homeowners is not. Furthermore, renter-occupied buildings can be depreciated for tax purposes by the owner, and frequently are purchased for purposes of sheltering income by using accelerated depreciation to create losses that can offset other income.

On balance, the cost of capital for multi-family units would rise initially by 12% under *Treasury II*, from 21.2% per year to 23.0%. In contrast to the case of single-family homes, very little of the increase is attributable to the reduction in marginal tax rates. The reason is that, while lower rates do raise after-tax financing costs, in the case of multi family structures there is a partial offset that occurs as the flow of income generated by the rental units is taxed at the lower rate as well. As in the case of single-family units, the loss of the property tax deduction significantly raises the cost of capital for structures.

The depreciation rules for residential buildings in *Treasury II* have received considerable attention and have been poorly received by the real estate industry. In the proposed code, the write-off period for residential structures would be lengthened from 18 to 28 years and the allowances in the first several years would be reduced significantly. In addition, the depreciation schedule would be adjusted each year to reflect the effects of inflation on the replacement value of the building. At today's inflation rate and in *present value terms*, the proposed depreciation rules are no less generous than those now in force. Hence, for an investor purchasing an apartment building as a long-term investment, the new depreciation rules would not change the rental price of multi-family housing very much. However, most such buildings are usually held for shorter periods. For a more typical seven year investment period, the proposed depreciation schedules would raise the cost of capital by 4%. *Treasury II* thus discourages investment in multi-family housing, adding to the concerns of the real estate industry.

Turning next to business capital, the rental price for producers durables would increase by nearly 11%, from 17.57% per annum to 19.46%. Because corporate income is subject to two layers of taxation, the cost of capital for equipment (and nonresidential structures) depends not only on the corporate tax code but also on the tax rates on income and capital gains faced by shareholders. Thus, the reduction in personal tax rates, by raising the after-tax rate of return corporations must offer shareholders, works to raise the rental price of equipment by 1.76%. Similarly, the reduction in the exclusion on capital gains income from 60% to 50%, which will force corporations to pay a higher dividend return in order to protect stockholders' overall after-tax yield, and thus raise the cost of capital modestly.

Introduction of the Capital Cost Recovery System (CCRS), by itself, would actually serve to lower the cost of equipment by 6.26%. Even without the adjustment of depreciation schedules to reflect the effects of inflation on the replacement value of equipment, CCRS would be only slightly deleterious. Indeed for most classes of equipment the proposed schedules are "frontloaded" relative to schedules provided for in ACRS. Allowing inflation adjustments ensures that, at today's inflation rate and in present value terms, the new schedules are more advantageous than the current ones.

The reduction of the marginal corporate tax rate from 46% to 33% lowers the cost of equipment by 0.49%. This impact, which upon first consideration may appear surprisingly small, actually results from offsetting effects. On the one hand, the stream of profits generated by equipment would be taxed at a lower rate, tending to lower the rental price of equipment. On the other hand, the tax advantages of both depreciation and leveraged financing are smaller at the lower profits tax rate, tending to increase the rental price. The overall effect is only slightly favorable.

The factor of overriding importance in determining the initial impact of *Treasury II* on cost equipment is the elimination of the Investment Tax Credit. Recission of the credit alone adds 15.25% to the cost of capital for producers durables. This is more than enough to swamp the effects of the advantageous provisions of the proposed code, and constitutes a substantial disincentive for investment.

For nonresidential structures, the cost of investment would rise initially from 15.88% under the current code to 16.3% under *Treasury II*, an increase of only 2.64%. As was true in the case of equipment, both the reduction in personal tax rates, the smaller exclusion for capital gains, and the elimination of the investment

tax credit raise the rental price for structures. The effect of doing away with the tax credit is comparatively small for structures because only a portion of expenditures that are classified as such in the National Income and Product Accounts are eligible for the credit. Any adverse effects on the cost of capital, however, are nearly offset by the advantages of CCRS -- which, at the current inflation rate and in present value terms, provides depreciation schedules for structures more advantageous than the current ones -- and the benefits of the lower profits tax rate.

Finally, *Treasury II* initially would raise cost of capital for business inventories by an insignificant amount. Because the current rate of change in the price index for inventories is actually negative, the switch to indexed-FIFO would actually work to raise this cost of capital, although the expectation is certainly that in the environment of modest inflation generally anticipated over the next several years the opposite would be true. Balanced against this is the increase in the cost of inventories that would occur as the reduction in the corporate profits tax rate raises the after-tax cost of borrowing by firms to finance inventories.

Are There Alternatives?

The President's reforms are not cut in stone and prudence suggests that, before rushing to acclaim or condemn the proposed tax treatment of business income it, we examine other options. As regards investment, adopting changes that eliminate or mitigate the rise in the cost of equipment may prove desirable provided that it is accomplished without grossly distorting the allocation of resources over longer periods. In addition, any changes necessarily must maintain the "revenue neutral" aspect of the overall package.

One possibility is to maintain the investment tax credit (or some portion of it), recouping the revenue by not lowering the corporate tax rate as aggressively as proposed. As noted above, it is the rescission of the tax credit that accounts for the lion's share of the increase in the cost of equipment, while the reduction in the marginal corporate tax rate does little to reduce the cost. Therefore, a combination of a higher (than 33%) corporate tax rate combined with an investment tax credit could lessen the rise in the cost of equipment while maintaining revenue neutrality. It may be argued, however, that this combination is no more efficient than current practice in terms of the allocation of resources.

A second possibility that is generally viewed as "neutral" in its allocative implications is to permit full first year expensing of investment expenditures, while eliminating the investment tax credit, any dividend exclusion, and the expensing of interest payments. This approach would mitigate (but not eliminate) the initial increase in the cost of equipment. It would also entail large revenue losses initially that would have to be paid for by a tax increase somewhere else, be it for corporations or individuals.

Table 1
Estimated Macroeconomic Effects of
The President's Tax Reform Proposal
(percentage difference unless otherwise noted)

	Years From Implementation				
	1	2	3	4	5
Real GNP	-1.6	-1.2	-0.8	-0.6	-0.2
Cumulative Difference (Billions of 72\$)	-\$26.3	-\$46.8	-\$60.6	-\$71.8	-\$76.5
Price Level	-0.2	-0.6	-1.1	-1.5	-2.0
Unemployment Rate (percentage points)	0.8	0.6	0.6	0.3	0.1
Federal Deficit	3.8	5.2	5.3	5.0	3.4
Cumulative Difference (Billions of Dollars)	\$8.4	\$20.8	\$33.5	\$45.5	\$53.5
Housing Starts	-14.3	-5.0	-0.3	-0.6	2.5
Real Consumption Expenditures	-1.3	-1.3	-1.1	-1.0	-0.9
Real Fixed Investment					
Non-Residential	-3.6	-4.5	-4.3	-3.6	-2.3
Equipment	-4.1	-5.1	-5.2	-4.8	-3.8
Structures	-2.5	-2.7	-1.6	-0.5	1.9
Residential	-12.7	-4.3	0.1	-0.2	2.1
Treasury Bill Rate (percentage points)	-0.6	-0.8	-0.9	-1.2	-1.1
Corporate Bond Rate (percentage points)	-0.3	-0.6	-0.8	-0.9	-1.0
Real After-Tax Bond Yield (percentage points)	0.4	0.3	0.2	0.1	0.0

Note: Based on simulations of the Washington University Macroeconomic Model

Table 2
Estimated Impact of The President's Tax Reform
Proposal on the Cost of Capital
(percentage difference)

	Years from Implementation				
	1	2	3	4	5
Business Capital					
Equipment	10.2	9.2	7.1	7.2	6.6
Structures	0.6	-2.4	-3.0	-6.0	-9.0
Residential Buildings					
Single Family	7.9	4.6	2.8	3.7	1.5
Multi Family	10.2	6.1	2.3	2.6	1.4
Consumer Durables	0.0	-1.8	-2.9	-2.5	-1.5
Inventories	-3.6	-8.3	-13.8	-19.3	-20.5

Table 3
Estimated Impact of The President's Tax Reform
Proposal on the Stocks of Investment Goods
(percentage difference)

	Years from Implementation				
	1	2	3	4	5
Business Capital					
Equipment	-0.6	-1.4	-2.3	-2.8	-3.1
Structures	-0.2	-0.4	-0.6	-0.6	-0.4
Residential Buildings					
Single Family	-0.7	-1.0	-1.0	-0.9	-0.7
Multi Family	-0.3	-0.7	-1.1	-1.2	-1.3
Consumer Durables	-0.7	-0.8	-0.4	-0.2	-0.0
Inventories	-0.7	-1.0	-0.8	-0.4	0.2

Table 4

Impacts of Treasury II on the Cost of Capital

Rental Price (%)	consumers durables	single family starts	multi family starts	producers durables	nonres- idential structures	business inventory
Current Code	22.47	18.00	21.23	17.57	15.88	9.53
Treasury II	22.89	19.80	23.78	19.46	16.30	9.54
Percent Change in Rental Price Due To:						
All Provisions	1.87	10.00	12.00	10.76	2.64	0.10
19% Lower Marginal Personal Rates	1.87	4.89	0.84	1.76	3.72	0.00
50% Capital Gains Exclusion	0.00	0.00	0.00	0.46	0.94	0.00
No Property Tax Deduction	0.00	5.89	6.00	0.00	0.00	0.00
Capital Cost Recovery System	0.00	0.00	4.40	-6.26	-2.64	0.00
(Without Indexing)	0.00	0.00	31.00	2.56	11.02	0.00
Index Inventory Profits	0.00	0.00	0.00	-0.63	-0.63	1.15
Corporate Profits Tax Change from 46% to 33%	0.00	0.00	0.00	-0.49	-5.79	-0.94
Eliminate ITC	0.00	0.00	0.00	15.25	6.86	0.00

Source: Center for the Study of American Business

**STATEMENT OF DR. DON FULLERTON, ASSOCIATE PROFESSOR
OF ECONOMICS, UNIVERSITY OF VIRGINIA: AND VISITING
SCHOLAR, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC
POLICY RESEARCH**

Dr. FULLERTON. Thank you, Mr. Chairman. I am very pleased to be invited to testify about the effects of the tax reform proposals on capital formation. I think in the brief time that I have I would most usefully provide some information from computer calculations I have been doing at the University of Virginia on the current law, Treasury proposal, and the White House plan. So, if you have a copy of the testimony, you might turn directly to the first figure at the back. These marginal effects of tax rates calculate for a new investment in a number of different types of assets the total expected tax over the life of the asset as a fraction of the total expected income. So, it is for new investment only and therefore does not say anything about the revenue impact of the proposal, but it really addresses the issue of incentives to invest. These calculations take into account the statutory corporate rate, the depreciation allowances over the life of the asset, the investment tax credit, the historical cost depreciation, interest deductions, taxation at the personal level on interest and dividends, and capital gains. The first figure shows how, for the current law, equipment is subsidized but that that subsidy is reduced or the tax is raised with higher inflation because those allowances are based on historical costs. The effective tax on structures also rises with inflation because of historical cost depreciation, but on other assets that do not get depreciation allowances, the taxes fall with inflation because inflation pushes up nominal interest rates that are deducted at a high statutory rate of the corporation. Within these calculations, by the way, the corporate tax amounts to really no additional incremental tax on new investment. That is to say, on the average marginal investment, it is completely offset by depreciation allowances, interest deductions, and investment tax credits. In contrast, the second figure shows how the Treasury plan would have very carefully tried to index the income tax base, that is, to index depreciation allowances, to index capital gains so that only real capital gains would be taxed, and to index interest income or expense. So, the second figure in the testimony shows how flat these effective tax rates are for different rates of inflation. It really eliminates the interference of inflation, but the Treasury plan would have raised the overall effective tax rate according to these calculations. The third figure shows the White House plan, and here you can see how the reacceleration of depreciation allowances under the CCRS—the capital cost recovery system—have reintroduced some advantages to equipment, even though there is no longer an investment tax credit and have reduced effective tax rates relative to the Treasury plan. The historical cost depreciation has been indexed so that there is no longer that reason for taxes to increase with inflation, and there will be an option for indexing capital gains after 1991. Now, the effective tax rates in the figure fall slightly with inflation because nominal interest deductions are retained, but the effect is not as dramatic as under current law, and this is important because the statutory rate for the corporation for these nomi-

nal interest deductions would be reduced to 33 percent, a number much closer to the statutory rate at which individuals would include nominal interest receipts. So, under the White House plan, there would no longer be such a subsidy for debt-financed investment. The rate at which deductions are taken would be very similar to the rate at which nominal interest is included. So, taxes do not fall very much with inflation. In summary, the White House plan under these calculations would not significantly raise or lower overall effective tax rates, but they would go a long way toward leveling a very diverse set of rates that are currently very low or subsidized on equipment, very high on structures—all those assets would be treated much more equally—debt would be treated much more similarly to equity, and the corporate sector would be treated more similarly to the noncorporate sector. Thank you.

The CHAIRMAN. Thank you very much. Ernie Christian?

[The prepared written statement of Dr. Fullerton follows:]

Testimony
of Don Fullerton
Associate Professor, University of Virginia
Visiting Scholar, American Enterprise Institute
before the
Senate Finance Committee
June 20, 1985

Mr. Chairman and members of the Committee, I am very pleased to be invited to testify about the effects on capital formation of The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity. I will also comment briefly on the Treasury Department's November 1984 proposal Tax Reform for Fairness, Simplicity, and Economic Growth. I'm not sure whether it means anything that "growth" moved up a notch in the list of goals in these titles, but I will present some results that suggest a corresponding change in priorities.

No computer model can adequately capture all of the ways in which a comprehensive tax reform proposal might affect capital formation and economic growth. We can expect complicated macroeconomic effects, temporary dislocations, redistributions of income, new savings patterns, and changes in corporate financial behavior. You will undoubtedly hear about many of these effects from others, and so I would like to concentrate on how these tax proposals affect the overall incentives to save and invest in different types of assets.

The "average" effective tax rate looks at the actual taxes paid in some year as a fraction of actual capital income. These taxes may be

relevant for cash flow and tax revenue associated with existing capital, but they may not be relevant for the expected future tax on a new investment, especially with a change in tax law. The "marginal" effective tax rates, shown in the attached table, look at a number of alternative new investments in the corporate sector, the noncorporate sector, and owner-occupied housing. These estimates assume that savers expect a 5 percent real after tax rate of return and a 4 percent rate of inflation. They include the statutory rate of corporation tax, available investment tax credits, accelerated depreciation allowances, state and local property taxes, business deductions for interest paid, and the personal taxation of interest, dividends, and capital gains. In this sense, they measure the total expected tax on each new investment, as a fraction of the total expected return.

The first column indicates that the current law heavily subsidizes equipment. Investment credits, ACRS, and interest deductions are sufficient together to offset not only the corporate tax on future income from the asset, but any personal tax and property tax as well. Corporations expect positive total taxes on structures, inventories, and other assets, but the effective rates are still considerably less than the combination of statutory rates on corporations and individuals.

Because of these credits and allowances, the overall rate of 31 percent in the corporate sector is not any different from the overall rate of 31 percent in the noncorporate sector. Indeed, the current corporate tax system does not collect any expected revenue from the overall marginal investment in these calculations, as simple repeal of the corporate tax does not reduce this marginal effective tax rate.

The 17 percent rate on owner-occupied housing reflects only the property tax, and the fact that homeowners deduct mortgage interest payments at an overall marginal rate that is slightly greater than the overall marginal rate of interest recipients. All sectors together would pay a tax of 26 percent on the income from new investment, but this number masks a considerable degree of variation among different kinds of investment. The weighted standard deviation of the different pretax rates of return is shown in the bottom row.

The first figure shows similarly random effects under the current law, where inflation increases the marginal effective total tax on equipment and structures, because of historical cost depreciation. It decreases the effective tax on other assets, because nominal interest is deducted at a corporate rate that greatly exceeds the overall marginal rate for interest recipients. Much interest, in fact, is received by tax-exempt institutions such as pension funds.

The Treasury Department's November 1984 plan would have completely removed these effects of inflation. It would have measured carefully the real income from each asset, by indexing depreciation allowances, capital gains, and interest paid or received. Figure 2 shows that all corporate assets would be treated very similarly under any expectations about inflation, while the 22 percent rate for owner-occupied housing falls slightly with inflation because that plan would have maintained the deductibility of nominal mortgage interest.

Moreover, the second column of the table reveals that the Treasury plan would have made the corporate tax system back into a real tax, with

an overall rate of 43 percent. The rate on noncorporate business does not change much, but the rate on owner-occupied housing increases from 17 to 22 percent because of the lost deductibility of state and local taxes. By treating equipment and structures much more similarly, the weighted standard deviation of differing pretax rates of return would have fallen from .0171 to .0117, reflecting the possibility for more output through the more efficient allocation of resources.

The White House proposal, then, would still remove the investment tax credit and reduce statutory rates, but it would re-accelerate depreciation allowances. The third column indicates that equipment would benefit more than other assets by these investment incentives, possibly to compensate in part for removal of the credit. The overall rate in the corporate sector falls back to 34 percent, not much higher than the estimate for current law. Also, I should note that the current corporate sector rate is reduced by the White House plan, under some alternative sets of assumptions in this model.

The rate in the noncorporate sector is not affected very much by any of these plans, while the rate for owner-occupied housing rises to 23 percent because of lost state and local tax deductibility. Most importantly, the reduction of the high rate in the corporate sector and the increase of the low rate in the housing sector together serve to reduce the weighted standard deviation of pretax rates of return, from .0171 to .0093. The much more equal tax treatment of the three different sectors means that capital will tend to allocate itself to the most productive uses instead of to the most lucrative tax breaks.

Finally, Figure 3 shows that while CCRS readmits some beneficial treatment of equipment, the remaining indexing provisions help to insulate the overall tax system from most of the effects of inflation. Rates fall somewhat because nominal interest is still deducted at a corporate rate that exceeds the overall personal rate on interest income, but the corporate rate for these interest deductions is reduced from 46 to 33 percent.

Too much attention has been paid, I believe, to the issue of whether these tax reforms increase or decrease the overall cost of capital or effective tax rate. In fact I find that the current overall tax cost might rise or fall under the White House plan, depending on the assumptions used in the model. Moreover, we know very little about how businesses react to these incentives. As a consequence, I would not put much stock in any claims about the total level of capital formation.

Instead, I think the important results to come out of this analysis are those that suggest a much more uniform treatment of different assets and sectors under the White House plan. Under these conditions, even with no additional capital formation, a given stock of capital can be used to produce more output. Investment decisions will be based on productive returns rather than tax returns. The plan would also eliminate the interference of inflation, and make for a more rational adherence to the intended effects of tax policy.

Thank you.

Marginal Effective Total Tax Rates

	<u>1985 Law</u>	<u>Treasury</u>	<u>White House</u>
Corporate Sector Tax Rates			
Equipment	-.183	.402	.245
Structures	.379	.456	.363
Public Utilities	.295	.435	.297
Inventories	.416	.424	.388
Land	.449	.448	.419
Overall Corporate Rate	.311	.431	.344
Noncorporate Sector Tax Rates			
Equipment	-.101	.273	.202
Structures	.281	.314	.280
Public Utilities	.210	.328	.259
Residential Structures	.326	.353	.327
Inventories	.305	.289	.287
Land	.333	.320	.317
Residential Land	.382	.373	.371
Overall Noncorporate Rate	.307	.327	.310
Owner-Occupied Housing Tax Rate	.172	.217	.230
Overall Tax Rate	.263	.335	.294
Standard Deviation	.0171	.0117	.0093

From Don Fullerton, "The Indexation of Interest, Depreciation, and Capital Gains: A Model of Investment Incentives," American Enterprise Institute Occasional Paper, Washington, D.C.

Figure 1

Marginal Effective Total Tax Rates (METTR) Under Current Law

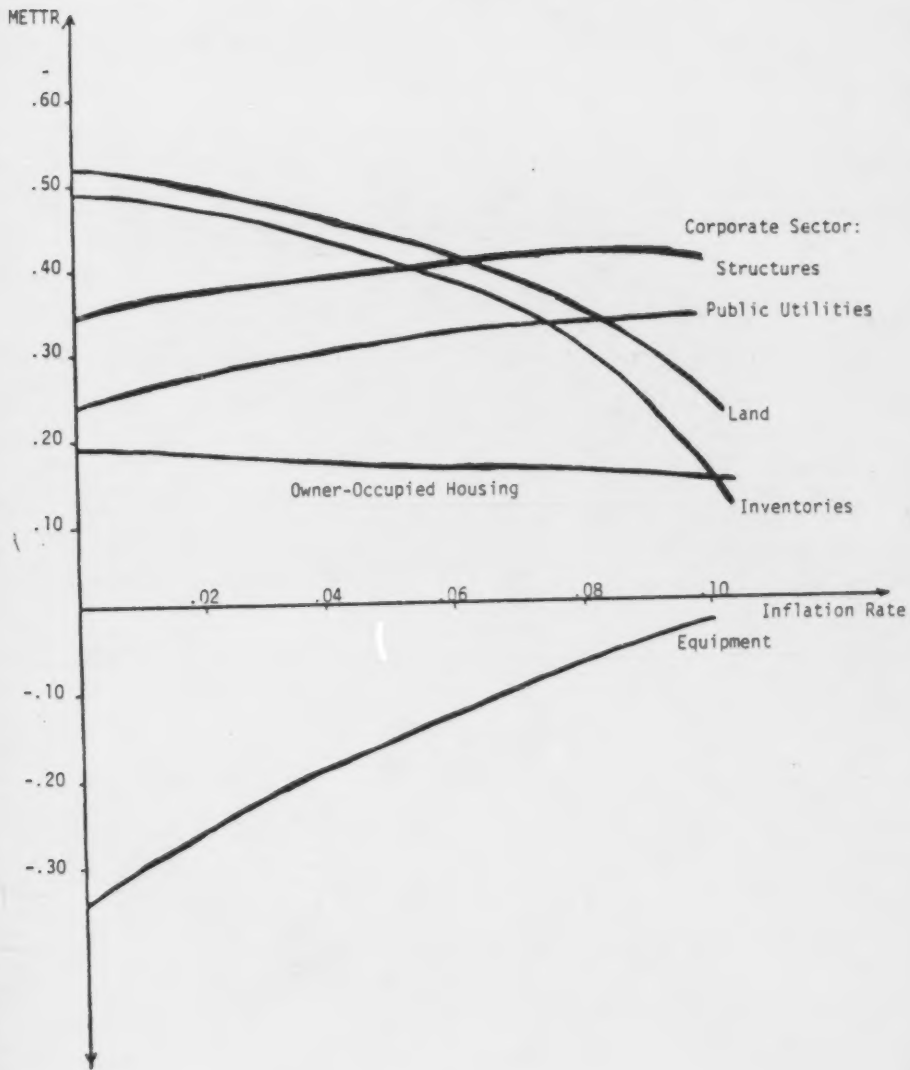


Figure 2

Marginal Effective Total Tax Rates (METTR) Under the Treasury Plan

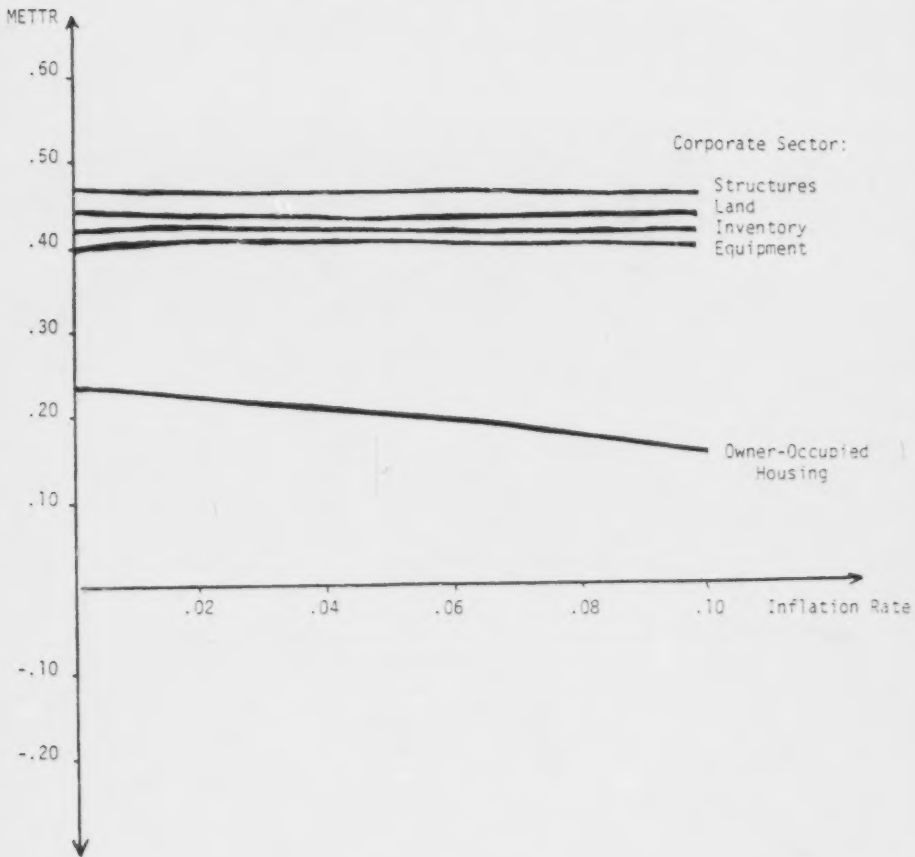
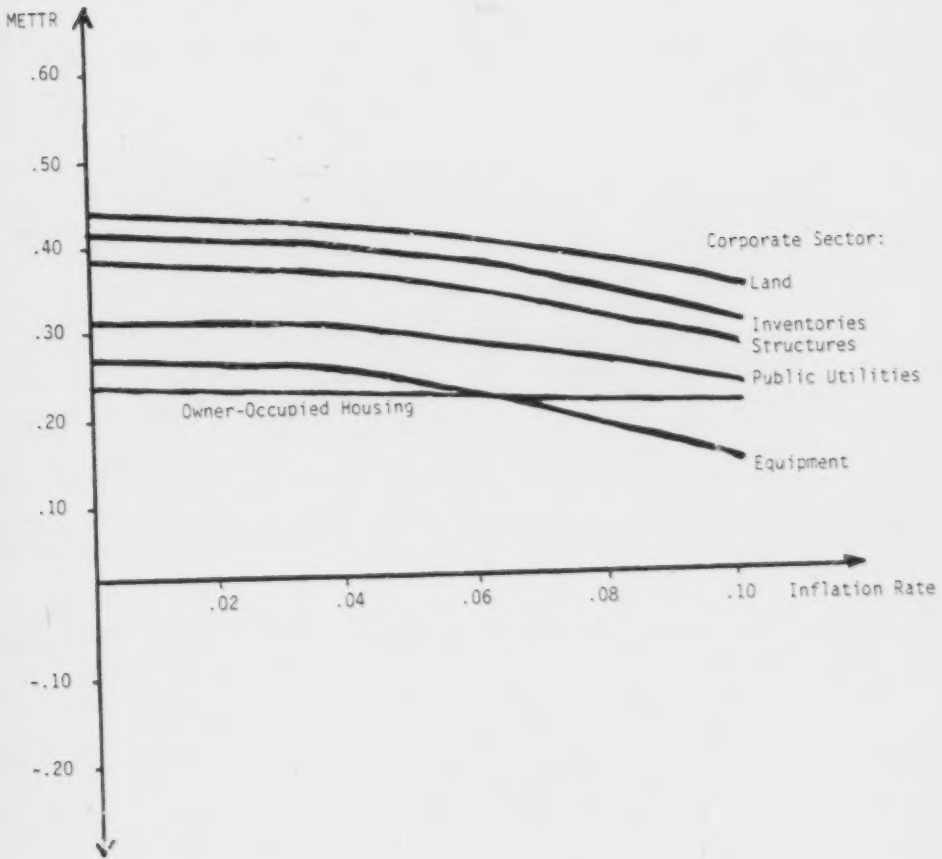


Figure 3

Marginal Effective Total Tax Rates (METTR) Under the White House Plan



STATEMENT OF ERNEST S. CHRISTIAN, JR., PATTON, BOGGS &
BLOW, WASHINGTON, DC

Mr. CHRISTIAN. Thank you, Mr. Chairman. The administration's proposed CCRS depreciation system is, in my opinion, neither fair nor neutral and will promote neither productivity nor employment in the United States. I emphasize in the United States. The administration's proposal may promote employment outside the United States. I know of no econometric study projecting that the administration's proposal will enhance GNP growth on any sustained, material basis. Most project somewhat lower levels of GNP growth. Taking into account the international dimension, it seems to me the ingredients are present for a substantial negative impact on productivity and GNP. The strong dollar already exerts great pressure on U.S. firms to manufacture abroad and sell back into the U.S. market, in the words of a recent Wall Street Journal article, for U.S. firms to "become the foreign competition." The administration's proposal to reduce taxes on sales of products in the United States, while at the same time increasing the tax burden on the manufacture of products in the United States, could accelerate this process. After all, capital is mobile. Make no mistake—the administration's proposal does substantially increase the cost of capital equipment in the United States. Under the present value, after tax method, the increase is at least 10 percent, assuming in both cases the reduced 33 percent corporate tax rate proposed by the administration. The reduced corporate tax rate is not a sufficient offset. The key is the ratio of capital investments to profits earned by the particular firm. If that ratio is high, the company will be hurt more by the repeal of the investment tax credit and ACRS depreciation than it will be helped by rate reduction. The most serious effect will be the large reduction in internal cash flows for companies that do have a high ratio of capital investment to profit. These companies will either be forced to reduce their investment in capital equipment or to borrow more. Keep in mind, at the same time the Treasury will also be borrowing at least as much as it otherwise would from the financial market. If the administration's proposal isolated, the United States would cease to be competitive with its principal international competitors in terms of cumulative capital cost recovery deductions (or deductions equivalents) allowed during the first few years after an investment is made. I believe, Mr. Chairman, the committee has before it this bar chart which shows that, as a practical matter, if the administration's proposal were enacted, the United States would essentially be last in year 1, last in year 2, last in year 3, and basically, last in year 5, also. If the comparison were made on a present-value basis, instead of on the more critical cash flow basis, some data indicate that the United States would be somewhere in the middle of the pack internationally but certainly not out in front of the competition. But I have said the present value comparison is the least relevant. The cash flow comparison is what is critical. Equipment is not bought and taxes are not paid with "certificates of present value," if there were such a thing. The present value is, after all, merely the discounted present value of some elongated stream of deductions stretching out into the future. Keep in mind that Treasury has pro-

posed to index depreciation for inflation under the CCRS proposal. The Treasury has managed to keep its CCRS depreciation proposal in the middle of the international pack only on a present value basis and only by means of the inflation adjustment. But how real is that inflation adjustment? If inflation rates increase substantially—to say, 10 percent, heaven forbid, indexing of depreciation would be very expensive to the Treasury and would jeopardize the ability to maintain the tax rate reductions which the administration has also proposed. One can readily foresee the Treasury proposing to change the indexing for inflation at some point in the future to CPI minus 3, or CPI minus whatever. In that regard, the administration's proposal to retroactively repeal ACRS back to 1981, by means of a so-called recapture tax is not much of a confidence booster in terms of businessmen believing that the indexing of depreciation will be maintained. On the other hand, without indexing for inflation, even at present inflation rates, the Treasury's CCRS depreciation would be a disaster for capital recovery in the United States, even on a present value basis. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared written statement of Mr. Christian follows:]

STATEMENT
OF
ERNEST S. CHRISTIAN, JR.
BEFORE
THE COMMITTEE ON FINANCE
UNITED STATES SENATE

June 20, 1985

Re: A Critical Analysis:
Capital Formation under the
Administration's Tax Proposal

I. Overall Perspective -- The Need for Balance

In reality, there are two tax bills confronting this Committee. One would drastically reduce tax rates for individuals and corporations. The efficacy and appeal of lower rates and lower tax payments is obvious. The other tax bill -- the tax increase bill -- would drastically rearrange the tax base, greatly increase taxes for many, and result in massive transfers of wealth among persons, among sectors, and among regions. Geographically, the heaviest burden will fall on the Northeast and Midwest. Sectorally, the heaviest burden will fall on investment in machinery and equipment in the U.S. The risks inherent in this tax increase bill should be obvious, also.

The task of this Committee will be to find some appropriate balance between rate reduction, on the one hand, and base broadening, on the other. Rates do not have to be reduced to 35%, 25% and 15% for individuals and 33% for corporations. Instead, individual rates could be reduced to 36%, 26% and 16% or to any other level which is substantially lower than present law. The proposed corporate rate could be similarly adjusted.

The goal of reducing marginal tax rates is not necessarily to produce a tax cut, as desirable as a tax cut may also be. Moreover, a tax cut of \$135 billion for individuals over five years, as proposed by the Administration, is dubious in the face of a \$200 billion federal deficit. The essential rationale for lower rates is to reduce the tax effect at the margin on earning,

Ernest S. Christian, Jr. is a former Treasury tax official invited by the Committee on Finance to testify on capital formation issues.

spending or saving an additional dollar and, thereby, to enhance effort, productivity, and resource allocation.

A reduction in marginal tax rates (and any accompanying tax cut that may be desired for other reasons) does not have to be accomplished all at once. Rate cuts are the easiest tax changes to phase in over a period of time. The timing of rate reduction should be a matter of balance between the good to be achieved by rate reduction and the potential for damage through other tax changes that are used to pay for rate reduction.

I would dramatize this risk/reward or reward/risk equation as follows:

It would profit a man little to gain one extra point of rate reduction if in the process he lost his job and had no income.

Serious risks are posed by the Administration's proposal to repeal the investment tax credit and ACRS depreciation both prospectively (through the adoption of CCRS, the Administration's proposed cost recovery system) and retroactively (through a combination of the Administration's newly proposed, so-called recapture or windfall provision and the structure of the proposed minimum tax). These changes in our capital cost recovery system would increase the costs of capital equipment in the U.S. and decrease the cash flow of businesses that acquire large amounts of capital equipment. The likely consequences are reduced levels of capital investment, lower productivity, and the export of both plants and jobs. In addition, these changes may lead to higher interest rates, lesser GNP growth, and higher deficits.

Fortunately, it is possible to achieve substantially reduced marginal rates of tax for individuals and corporations while reducing or minimizing the risk associated with the more extreme measures proposed by the Administration in the capital formation area. I have developed several alternative versions to Treasury's November 1984 tax reform plan that accomplish this goal. I am confident that this Committee can develop a low risk alternative to the Administration's proposal.

II. Capital Cost Recovery under the Administration's Proposal

A. Introduction

The Administration proposes to repeal the ITC and ACRS and substitute a depreciation system that is neither fair nor neutral and which will promote neither economic growth nor employment in the United States.

If the present value of future profits to be earned from new equipment exceeds its cost, the current tax law, at current inflation rates, neither encourages nor discourages a businessman from investing in the equipment. The current tax system does not discourage profitable investments; it is neutral and fair in this

regard. On the other hand, under the Administration's proposal, the present value of profits on most manufacturing equipment would have to exceed 105.4% of equipment cost for a corporation to make any after-tax profit on the equipment.^{*/} If the present value of profits is less than 105.4% of cost, the corporation will not buy the equipment even though the purchase would be profitable without the tax system. This result is counter-productive; the purpose of an income tax system is to raise money by taxing income -- not to prevent income from being earned. Even taking into account the proposed reduction in the corporate tax rates from 46% to 33% (as all these comparisons do), the Administration's proposed depreciation system (CCRS) for most investments in equipment would be more favorable than the ITC and ACRS under present law only if the present value of the profit were to exceed 132% of equipment cost. CCRS places a higher effective tax rate, or requires a greater return, on equipment in higher number CCRS classes than it does on equipment in lower number CCRS classes. Thus, the Administration's proposal -- rather than being neutral and market-oriented -- exerts a strong regulatory influence. The Administration penalizes a wide array of equipment investment in a normal range of profitability even though such investment is critical to a healthy national economy.

In the materials accompanying and justifying Treasury I, the Treasury observed that many basic industries were not growing in productivity and job creation as much as would be desired. Having observed that situation, the Administration response has been to impose a massive tax increase on those in the capital-intensive sector of the economy. I question the logic of that.

B. The Degree of the Increase in the Cost of Capital Equipment

Let there be no doubt. The Administration's proposal does increase the cost of capital equipment in the U.S. That increase is substantial and is not offset by reducing the corporate tax rate to 33% as also proposed by the Administration. There are several ways of measuring the change in the cost of capital, all of which confirm that there is a substantial increase.

1. Present Value of Deductions

As Table 1 demonstrates, when the investment tax credit is treated as a deduction-equivalent (at a 46% tax rate), the present value of deductions under the current cost recovery system for 3-year and 5-year property exceeds the present value of deductions for the same property under CCRS. This holds true for inflation rates as high as 10%. In the case of a comparison

^{*/} Except as otherwise noted, the percentages discussed here are based on Treasury's present value computations made assuming a 5% inflation rate, a 4% real rate of return and a 9.2% after-tax discount rate.

between ACRS/ITC for 5-year property and CCRS Class 4, which would include most 5-year property, this holds true for even higher inflation rates.

Under a 5% inflation assumption, the present value of deductions under ACRS/ITC would exceed the present value of deductions under CCRS Class 4 by over 13%.

2. After-Tax Cost of Investment

The after-tax cost of an investment may be computed by subtracting from the nominal cost of the investment an amount equal to the present value of tax benefits attributable to the investment. An assumed tax rate must be used to determine the tax benefits attributable to deductions. As Table 4 demonstrates, the after-tax cost of a \$1,000 investment in equipment is greater under CCRS than under ACRS/ITC at both a 46% tax rate and at a 33% tax rate. At a 5% inflation rate, the after-tax cost of CCRS Class 4 equipment is over 10% greater than the after-tax cost under current law.

3. Required After-Tax Profit

The Administration's tax proposal would lower the corporate tax rate to 33%. Will the benefits of rate reduction offset the increase in the cost of capital? The answer appears to be no in most cases.

Table 2 shows the present value of pre-tax earnings required to produce an after-tax profit on a \$1,000 investment under ACRS/ITC at a 46% tax rate and CCRS at the proposed 33% tax rate. Each value listed in Table 2 is the present value of pre-tax earnings at which the present value of after-tax earnings would equal the present value of the after-tax cost of a \$1000 investment in equipment.

Table 2 demonstrates that certain capital investments which would generate an after-tax profit if there were no income tax and which generate an after-tax profit under the current income tax structure will generate an after-tax loss under the Administration's proposal. Thus, certain productive investments will not be made if the Administration's proposal is adopted. For example, if the present value of the pre-tax earnings for a \$100 million investment in a chemical plant is \$104 million, the investment will not be made if the Administration's proposal is adopted.

C. Large Reduction in Corporate Cash Flow

1. Cash Flow Versus Present Value

If the Administration's proposal is adopted, perhaps the most significant adverse effect on capital investment in the United States will come from the large decrease in the cash flow of capital-intensive companies.

**COMPARISON OF ACRS/ITC WITH CCRS
WITH RESPECT TO A \$1000 INVESTMENT**

TABLE 1

<u>Present Value of Deductions¹</u>	<u>Inflation Rate</u>		
	<u>10%</u>	<u>5%</u>	<u>0%</u>
ACRS 3-year property (no ITC)	\$865	\$908	\$957
ACRS 3-year property (with ITC) ²	969	1011	1058
CCRS Class 1	955	954	953
ACRS 5-year property (no ITC)	766	837	922
ACRS 5-year property (with ITC) ³	945	1012	1093
CCRS Class 2	940	940	939
CCRS Class 3	920	920	919
CCRS Class 4	891	890	889
CCRS Class 5	853	853	853
ACRS 18-year property	454	570	760
CCRS Class 6	760	610	610

TABLE 2

Present Value of Pre-Tax Earnings from Investment
Required to Produce an After-Tax Profit⁴

ACRS 3-year property (with ITC)	\$ 991
CCRS Class 1	1023
ACRS 5-year property (with ITC)	990
CCRS Class 2	1030
CCRS Class 3	1039
CCRS Class 4	1054
CCRS Class 5	1072
ACRS 18-year property	1366
CCRS Class 6	1192

TABLE 3

Percentage Increase in Profitability Required for
Investment if President's Plan is Adopted⁵

CCRS Class 1	3.2%
CCRS Class 2	4.0%
CCRS Class 3	4.9%
CCRS Class 4	6.5%
CCRS Class 5	8.3%
CCRS Class 6	-12.7%

TABLE 4

COMPARISON OF ACRS/ITC WITH CCRS
WITH RESPECT TO A \$1,000 INVESTMENT IN EQUIPMENT
(5% INFLATION)

	Present Value of Deductions*	After-tax Cost of Investment 46% tax rate	% Increase in Cost (46% tax rate)	After-tax Cost of Investment 33% tax rate	% Increase in Cost (33% tax rate)
ACRS 5-year prop. (no ITC)	\$ 837	\$ 615	-	\$ 724	-
ACRS 5-year prop. (ITC)	\$ 1,012+	\$ 534	-	\$ 638	-
CCRS Class 2	\$ 940	\$ 567	6.2%	\$ 690	8.2%
CCRS Class 3	\$ 930	\$ 577	8.1%	\$ 696	9.1%
CCRS Class 4	\$ 890	\$ 591	10.7%	\$ 706	10.7%
CCRS Class 5	\$ 853	\$ 608	13.9%	\$ 719	12.7%

* 9.2% discount rate (4% real rate of return, 5% inflation).

+ Includes deduction-equivalent of the ITC at a 46% tax rate.

- 1/ Source: The President's Tax Proposal. Present values are computed using a 4.0% real rate of return, which converts to a discount rate of 4% with no inflation, 9.2% with 5% inflation, and 14.4% with 10% inflation. These present values are overstated because they treat the first year's tax benefit as occurring immediately rather than at the subsequent estimated tax payment dates.
- 2/ Deduction value of ITC is determined at a 46% tax rate. Figures reflect basis adjustment and 6% ITC.
- 3/ Deduction value of ITC is determined at a 46% tax rate. Figures reflect basis adjustment and 10% ITC.
- 4/ These figures show the present value of pre-tax earnings (calculated at a 4% real rate of return, 5% inflation, 9.2% discount rate) required for the after-tax earnings to exceed the real cost of the investment (i.e., \$1000, reduced by the present value of the tax benefit from depreciation deductions and ITC, where applicable). The computations are made assuming a 46% rate for ACRS and a 33% tax rate for CCRS. This table shows, for example, that if the President's proposal is adopted a taxpayer will not make a \$1000 investment in Class 4 CCRS property unless the present value of the expected pre-tax return is \$1054. Thus, certain investments that produce a real profit in a no-tax environment or under current law actually generate an after-tax loss under CCRS.
- 5/ These figures are the percentage differences between the CCRS values in Table 2 and the corresponding ACRS values.

It is critical to make the distinction between the present value calculations of the type made by Treasury and the impact of a cost recovery system on a corporation's cash flow. The present value calculation is largely a computation used to compare two possible streams of deductions, assuming that a company can borrow at the discount rate used to determine the present value. Cash flow analysis tells us more about the immediate financial position of corporations. Of course, the financial condition of a corporation has a significant impact on its cost of borrowing.

Let's take a simple example. Suppose that under the current cost recovery system a taxpayer is entitled to expense, i.e., deduct immediately, the cost of investment. Under a hypothetical, proposed system, which I will call DCRS -- the delayed cost recovery system, the taxpayer must wait 15 years to obtain any deduction for an investment in equipment, but the deduction is equal to twice the cost of the equipment, as indexed for inflation. The present value of the deductions in the first case is 100% of cost. The present value of deductions under DCRS at a 4% real rate of return, would be 110% of cost. But would DCRS really be better for the taxpayer? The answer is no. During the next 15 years, the taxpayer would lose substantial deductions that it otherwise would have. The taxpayer would pay substantially higher taxes. At a 33% tax rate, the taxes would be increased by 33% of the amount of the investment made by the taxpayer in each of the next 15 years.

The impact of that tax cost is significant. It means that a corporation would have to borrow, reduce dividends, or sell more stock to finance the cost of new investment, or else reduce the amount of investment. If a corporation reduces its investment substantially, it may cease to be productive and go out of business. Yet, for practical purposes, the corporation may be in no position to increase its borrowing or to sell more stock because the value of its assets is not sufficient to secure the amount of additional debt or to support a high enough price for new stock. The "promise" of future tax deductions is not an asset that lenders will normally allow a corporation to borrow against. The borrowing problem is further complicated because many manufacturing companies have loan covenants that prevent them from borrowing more. Thus, to borrow more, companies may have to borrow not only to finance new investment but to pay off their old loans covered by the covenants. As companies lose the benefit of old, low-interest-rate loans and are forced to borrow without sufficient assets to fully secure their new loans, the cost of borrowing goes up. As the cost goes up, otherwise profitable investment may cease to be profitable.

This points out one fallacy with the present value argument. By using the same real discount rate to compare a more accelerated system with a less accelerated system, the computation fails to take into account that it will take more

borrowing to invest under the less accelerated system, and, as a result of the greater borrowing, the taxpayer's costs of borrowing will be greater. That means that a higher discount rate should be used for the less accelerated system when present value comparisons are made.

As the exaggerated example illustrates, any time that a depreciation system is changed from a front-loaded system with a short recovery period, such as ACRS/ITC, to a less front-loaded system with a longer recovery period, such as CCRS, there is a substantial short-term loss in cash flow to taxpayers. This means that corporations must raise or hold more cash to sustain an anticipated level of investment.

When considering the increased cost of borrowing that results from decreased cash flow, it is important to recognize that the issue is compounded to some extent by rate reduction. While rate reduction lessens the impact of the deferred cost recovery deductions, it does have one other adverse impact. It increases the real, after-tax cost of borrowing, assuming that interest rates hold constant.

Let me emphasize one point: The cash flow problem associated with the adoption of CCRS would result as much, if not more, from the replacement of an accelerated system with a less accelerated system than it does from CCRS itself. That is part of the reason that industrialized countries rarely replace a cost recovery system with a less favorable one.

2. Disguised Borrowing System

Under a tax system that is completely neutral with regard to investments, a taxpayer would be entitled to expense the cost of its investments. By deferring deductions through an inflation-indexed cost recovery system, the U.S. government would be essentially borrowing money from corporations and paying the corporations back at a later date when the deductions are claimed. In an indexed system, the government is paying interest in an amount equal to inflation; that is, the government is paying no real interest on its borrowing. This, of course, is unfair to businesses that are converted to lenders. The businesses must make up for the money that the government borrows from them by borrowing in the private market -- where they must pay interest in excess of the rate of inflation.

By moving from ACRS/ITC to CCRS, the government would be significantly deferring cost recovery. Thus, in effect, it is increasing and privatizing the federal debt. The benefits of this additional privatized federal debt are being used to reduce tax rates and not to reduce the federal debt. The impact of this privatized debt on the financial markets is uncertain.

3. Impact on Cash Flow

While the increase in the cost of capital equipment computed on a present value basis generally would be large (about 10%) if the Administration's proposal is adopted, the cash flow cost to capital intensive companies would be enormous. The overall size of this increase in the cash flow cost can, in general, be measured by the size of the Administration's proposed changes in the cost recovery system. As shown below, at current tax rates, the Administration's proposed changes relating to cost recovery would increase revenues by \$260 billion over a five-year period.

TABLE 5
CHANGES IN COST RECOVERY PROVISIONS
(Individuals and Corporations)
\$ billions

	<u>FY 1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>TOTAL</u>
Repeal investment credit	\$15.7	\$30.4	\$35.0	\$39.7	\$44.6	\$165.4
Recapture tax on prior depreciation	7.6	19.7	20.7	9.6	0	57.6
Change from ACRS to CCRS	0.4	-0.4	3.6	12.3	21.2	37.1
TOTAL GAIN	23.7	49.7	59.3	61.6	65.8	260.1

Most of this revenue gain is attributable to capital equipment. Since most of the gain is attributable to the repeal of the investment credit, the gain would be substantial even after rate reduction -- at least \$235 billion.

Rate reduction does not nearly compensate for this loss. The primary beneficiaries of corporate rate reduction will be corporations that are not capital intensive. Thus, substantial sums of money, in the form of additional taxes, will be taken from capital-intensive companies.

4. Recapture Tax On Prior Depreciation -- A Bad Situation Made Worse

In addition to the repeal of ITC and ACRS, which would increase the cost of capital equipment and increase the cash flow drain associated with an investment in capital equipment, the Administration has proposed a recapture provision that amounts to a retroactive repeal of ACRS for property placed in service between 1981 and 1985 and a retroactive repeal of ADR depreciation for property placed in service in 1980. Because corporations would pay the additional tax associated with the

recapture provision at the same time that their taxes increase as the result of the shift from ITC and ACRS to CCRS, the cash flow losses from repeal of ITC and ACRS are magnified. This problem is exacerbated by the fact that the companies that will bear most of the burden of the prospective repeal of ACRS/ITC are, in general, the same ones which made most of the investment in capital equipment in 1980 through 1985.

The proposed recapture tax is essentially a retroactive excise tax on a taxpayer's 1980-1985 investment. The additional tax paid by a taxpayer would be equal to a percentage of the cost of equipment placed in service. For example, the tax on five-year property placed in service in 1981 would be 7.7% of cost; the tax on 5-year property placed in service in 1982 would be 7.42% of cost. See Table 6.

The recapture provision has the same cash flow effect as if the Administration had made its CCRS proposal even more unfavorable and cut back capital recovery by an additional \$7.6 billion in 1986, \$19.7 billion in 1987, \$20.6 billion in 1988, and \$9.6 billion in 1989. This is not to suggest that the recapture provision has the same effect with respect to new capital investment as a further cutback in CCRS. Instead, this demonstrates the impact of imposing a \$56.5 billion corporate tax increase on the same companies that bear the brunt of the cutback in capital recovery provisions.

D. Recapture: A Faulty Concept That Cannot Be Justified

The Administration's proposed recapture provision would include in income over a three-year period 40% of a taxpayer's "excess depreciation" taken between January 1, 1980, and July 1, 1986. The Administration's position is that "excess depreciation" -- the excess of accelerated depreciation over economic depreciation for an item of property -- constitutes deferred taxable income that will be taxed after the crossover point, i.e., when the economic depreciation allowance would exceed the accelerated depreciation allowance. The Administration claims that a taxpayer that takes the accelerated depreciation deductions at a 46% tax rate, but would recognize income at a later time at a 33% rate has an unexpected benefit -- and that unexpected benefit should be recaptured in 1986-1988.

This analysis is far too simple. It, in effect, assumes that a taxpayer expects the so-called "excess depreciation" to be recognized in income and taxed at the maximum applicable rate. However, observations of capital-intensive companies make clear that companies have not and do not expect that their entire "excess depreciation" will be taxed at 46% soon after the crossover point is reached for each investment.

Prior "excess depreciation" with respect to an item of property will generally result in additional taxable income after the crossover point. In the case of a company that is

TABLE 6

ADDITIONAL TAX RESULTING
FROM THE ADMINISTRATION'S PROPOSAL
TO RECAPTURE PRIOR DEPRECIATION

(All figures are percentages of the original
cost of the property placed in service^{1/})

Placed in Service	Excess Depreciation ^{2/}	Taxable Excess ^{3/}	Tax on Excess ^{4/}	Tax in 1986 & 1987 ^{5/}	Tax in 1988 ^{6/}	Present Value of Tax ^{7/}
<u>5-Year Property</u>						
1981	58.33%	22.3%	7.70%	2.31%	3.08%	7.01%
1982	56.17	22.47	7.42	2.22	2.97	6.75
1983	43.50	17.40	5.74	1.72	2.30	5.22
1984	30.83	12.33	4.10	1.22	1.63	3.73
1985	17.67	7.01	2.31	0.70	0.93	2.10
<u>3-Year Property</u>						
1981	-	-	-	-	-	-
1982	20.00	8.0	2.64	0.70	1.06	2.40
1983	40.00	16.00	5.28	1.58	2.11	4.80
1984	41.50	16.60	5.48	1.64	2.19	4.99
1985	24.00	9.60	3.17	0.95	1.27	2.88
<u>15-Year Real Property</u>						
7-1-81	33.21	13.28	4.38	1.32	1.75	3.99
7-1-82	28.57	11.43	3.78	1.13	1.51	3.44
7-1-83	22.93	9.17	3.03	0.90	1.21	2.76
7-1-84	16.29	6.52	2.15	0.64	0.86	1.96
<u>18-Year Real Property</u>						
7-1-84	11.29	4.52	1.49	0.44	0.60	1.36
7-1-85	7.00	2.80	0.92	0.28	0.37	0.83

- ^{1/} For example, a taxpayer who put a \$100 million machine in service in 1982 would have an additional tax obligation of 7.42% of \$100 million, or \$7.42 million in 1987-1988.
- ^{2/} Excess of accelerated cost recovery deductions during the period 1-1-80 to 6-30-86 over the earnings and profits depreciation under section 312(k) for the same period. Computations assume: (1) half of 1986's depreciation allowance is allowable during the first half of 1986 and (2) no basis adjustments resulting from use of a full investment tax credit.
- ^{3/} 40% of column (2).
- ^{4/} 33% of column (3).
- ^{5/} 12% of 33% of column (2). This is the additional tax for each year.
- ^{6/} 16% of 33% of column (2).
- ^{7/} Present value of additional tax as of 1986 using a 9.2% discount rate.

continually investing in new property, the additional taxable income will be offset by "excess depreciation" on new property placed in service in years after the crossover point. This pattern will continue; excess depreciation on new property will continue to offset income attributable to excess depreciation on old property. In the simple case of a company with level investment in a no-inflation world, the income attributable to excess depreciation would not be recognized until the company reduces its investment or a less favorable depreciation system is adopted. When the benefit associated with excess depreciation is eventually recognized, the relevant excess depreciation is the excess of the aggregate tax depreciation over the aggregate economic depreciation on all items of property regardless of when placed in service. This illustrates that the fundamental premise underlying the Administration's position is wrong. Taxpayers do not generally expect that their "excess depreciation" associated with particular items of property in particular years will be recaptured and taxed in full in the foreseeable future.

The Administration's major error in developing the recapture tax was its focus on the tax associated with single items of property and its focus on only one of the many changes made in the Administration's tax proposal -- rate reduction. Substantial changes in the system of taxation will create benefits for some taxpayers and additional obligations for others. In assessing whether a taxpayer would obtain a unexpected benefit from changes in tax law, you must look at the changes in the aggregate. It is difficult to see how taxpayers that would pay more tax under the Administration's tax plan (disregarding the recapture tax) than under present law will obtain an unexpected benefit that should be subject to tax. But the proposed recapture tax would have its most significant impact on capital-intensive corporations that would pay more tax under the Administration's plan than they would under present law.

The Administration's proposal, while incorrectly looking at this issue on an item-by-item basis, fails to even take into account all factors relating to an item of property. Suppose that a corporation borrowed money on a long-term basis to finance an investment in equipment. The decrease in tax rates would create an unexpected increase in the after-tax cost of the interest payments. Fairness requires that this unexpected loss be taken into account in an analysis of unexpected gains.

Even if one were to accept the existence of a benefit attributable to excess depreciation, the Administration's proposal is flawed. The proposal incorrectly assumes that a corporation that does not have NOL carryovers has a 46% marginal tax rate. For example, if a corporation has substantial capital gains income and a small ordinary loss, an additional dollar of income would not increase the corporation's tax liability. If a corporation has ITC carryovers, the additional tax attributable to additional income may not be recognized until some uncertain future time. What could be more unfair than imposing a tax on

"excess depreciation" that did not even reduce a taxpayer's tax liability?

Rate reduction will always bring with it certain benefits. Shareholders of corporations that would pay less tax under the proposal will enjoy an increase in the value of their stock. Noteholders who anticipated that their interest income from long-term notes would be taxed at a 46% rate will receive an unexpected benefit. So will corporations that are earning income as a result of goodwill, research and development, intangible drilling or exploration costs, or other costs incurred and deducted prior to rate reduction. Foreign corporations that constructed plants abroad to produce inventory for sale in the United States at a 46% tax rate would benefit from a reduction in tax rates as would U.S. manufacturers, but would pay no recapture tax. Why did the Administration select only depreciation as the target for its revenue-raising penalty tax?

The Administration's tax proposal requires taxpayers which lose their deductions for additions to their bad debt reserves to include their bad debt reserves in income ratably over ten years. Taxpayers that are forced to switch to the accrual method of accounting would include adjustments in income over six years "in order to minimize large distortions in taxable income." A ten-year phase in would apply with respect to new accounting rules for costs of production. If there is any benefit attributable to "excess depreciation," it would almost certainly be recognized over a longer period than three years. Why then should the recapture tax apply over a three-year period in blatant disregard of its distortionary effect on income?

The answer is clear: when it came to the recapture tax, the Administration's need for revenue apparently outweighed its desire for fairness and sound economic analysis. There can be no doubt that the real purpose of the proposed recapture tax is to raise revenue. The proposed tax, which was not included in Treasury's idealistic November 1984 tax reform plan, first surfaced publicly after a \$30 billion error was discovered in revenue estimates.

Retroactive taxes of this type can cause taxpayers to lose faith in government. If companies had known that they were going to be required to pay a recapture tax with regard to prior investment, they may not have made the investment in the first place. That is why novel, retroactive taxes are unfair and may not be constitutional.

The Administration, in its zeal for rate reduction, has gone too far in an effort to reduce a revenue gap that might more properly be reduced through a phase in of rate reductions. Approximately the same amount of revenue could have been raised by applying a 35% corporate tax rate, rather than a 33% tax rate for five years. Had Treasury chosen to raise the additional revenue by adjusting rates, the burden would have been spread broadly across all corporations and functions, instead of being

concentrated on capital equipment and capital-intensive corporations.

E. Inflation Indexing: Fallacies and Dangers

The Administration's CCRS proposal is a numbers-manipulation game. The value of the system is very dependent upon indexing. However, if inflation becomes substantial, the depreciation system becomes extremely costly to the government. The total depreciation deductions claimed by businesses with respect to an investment in property may far exceed the actual costs of the investment. Both the public perception with regard to this type of excess depreciation and Congress's and future Administration's concerns with the growing deficit make inflation indexing an all too likely target for change. It is easy to imagine a situation in which there is substantial pressure to reduce the index to, say, inflation-minus-three-percent, or to eliminate indexing in its entirety.

The Administration's proposal to repeal retroactively, by means of the recapture provision, the current cost recovery system, which the Administration aggressively promoted in 1981, gives businessmen no confidence that inflation indexing would remain in place. The substantial risk that indexing would be repealed or reduced will cause businessmen to devalue future projected cost recovery deductions under CCRS. They will apply a higher discount rate for purposes of determining the present value of cost recovery deductions under CCRS, and the perceived cost of capital will be substantially higher. This uncertainty will cause taxpayers not to make certain productive and profitable investments.

Without indexing, the proposed CCRS system is disaster from both a present value and a cash flow viewpoint.

F. International Comparisons of Cumulative Cost Recovery Allowances

If the Administration's CCRS depreciation system were to be substituted for the ITC and ACRS, the U.S. would cease to be competitive with its principal international competitors in terms of cumulative cost recovery deductions allowed in the critical years following the time an investment is made and the equipment placed in service.

The bar graph appended to this testimony demonstrates that cost recovery deductions allowable under CCRS for the first few years that equipment is in service are significantly less than the deductions allowed by other leading industrialized nations.

The bar graph compares the cost recovery deductions that would be allowed for CCRS Class 4 property placed in service on July 1 (if the inflation rate increases to, and holds steady at, 5% per year) with the cost recovery deductions allowable for

machinery and equipment under current U.S. law and under the laws of other industrialized nations.*/

As the bar graph illustrates, if CCRS is adopted, the U.S. would rank dead last in the industrialized, free world in cumulative cost recovery deductions allowed for most equipment through each of the first three tax years that the equipment is in service. CCRS would rank last even if seven other industrialized countries were included.**/

CCRS can be viewed as a system under which the U.S. forces its businesses to lend to it, essentially interest-free, far more than other industrialized countries, through their depreciation systems, require corporations to lend to them. Why, at a time of high trade deficits and declining employment in the U.S. manufacturing sector, does the Administration propose a cost recovery system that is less favorable than those of our principal trading partners?

III. Consequences of the Proposed Large Increase in the Cost of Capital Equipment

The Administration's proposal to repeal the ITC and ACRS is fraught with risk and uncertainties. Among the possible results are less investment, lower productivity, fewer jobs, smaller GNP, greater budget deficits, larger trade deficits, and higher interest rates.

A. International Competitiveness: Export of Jobs Instead of Products

The U.S. economy has become increasingly "internationalized" in recent years. The potential folly of repealing ITC and ACRS is perhaps most apparent when looked at in the critical international dimension.

The increase in the cost of capital equipment in the U.S. will further impair the ability of U.S. companies to expand and modernize plants and equipment, further diminish the international competitiveness of U.S. companies and workers, and unfairly increase the vulnerability of U.S. production and jobs to imports. Moreover, the combined effect of increasing the tax

*/ The source of these data on other industrialized nations is a recent study by Arthur Andersen and Company. The study converted tax credits to additional cost recovery deductions that would reduce tax liability by the same amount as the credits.

**/ The Arthur Andersen study compared the cost recovery deductions of the U.S. with those of 15 industrialized countries. See the attached table. The "average" listed on the bar graph includes all 15 countries.

cost of U.S. manufacturing while decreasing the tax on sales of goods in the U.S. market and the more favorable cost recovery systems which exist in other industrialized nations would actually provide a positive incentive for U.S. companies to manufacture goods abroad for sale both back into the U.S. and around the world in export markets. The result would be a substantially increased trade deficit and a significant loss of jobs.

The ingredients for a strong net outflow of direct investment are already present. On April 19, 1985, the Wall Street Journal observed that the strong dollar exerts enormous pressure on U.S. investment to locate manufacturing facilities abroad and to, in effect, "become the foreign competition," viz, to manufacture abroad goods for sale in the U.S. domestic market and in world markets in competition with U.S.-produced goods.

That particular press report cited numerous specific examples of U.S. firms locating manufacturing facilities abroad. The cited outflow of investment, and indirectly of jobs, is a mere trickle compared to the flood that likely would occur if the cost of capital equipment is increased substantially by repeal of ITC and ACRS.

The present favorable climate for direct investment in plant and equipment in the U.S. created by the combined effect of ITC and ACRS has managed to ameliorate the enormous pressure from the strong dollar to manufacture abroad. Beginning in 1981 when ACRS was enacted, there has been a dramatic reversal in net capital inflows/outflows for direct investment.*/ The prior large net capital outflow has in 1981-1984 been converted into a large net capital inflow by both U.S.-owned and foreign-owned capital for direct investment in the U.S. This has accounted for at least one-third of the capital expansion in the economic recovery, which is still not complete. Other factors may have contributed to the net inflow of direct investment in recent years. On the other hand, the size of the net inflow in the face of a strong dollar is so dramatic that most of the net inflow must be attributed to the favorable capital investment environment created by the combination of ITC and ACRS beginning in 1981.

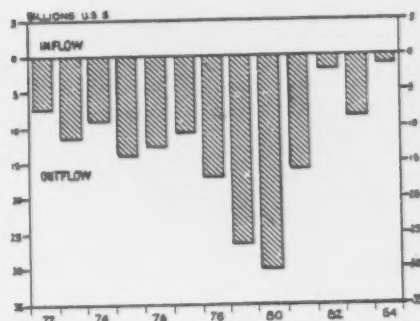
Were ITC and ACRS now to be repealed, and the full outflow pressure of the strong dollar to be unleashed, it is only logical to expect that huge amounts of U.S.-owned capital would flow outward to direct investment abroad, that an even larger portion

*/ These comments and other comments and charts in the next several pages on the international dimension of the repeal of ACRS/ITC are based on a paper presented by Daniel A. Hodes, Chief Economist, GTE Corporation, and Laurence J. Mauer, Associate Professor, St. John's University, at Harvard University on April 15, 1985.

SINCE 1980, U.S. COMPANIES HAVE PULLED BACK FROM INVESTING ABROAD AND FOREIGN COMPANIES HAVE INCREASED THEIR INVESTMENT IN THE U.S.

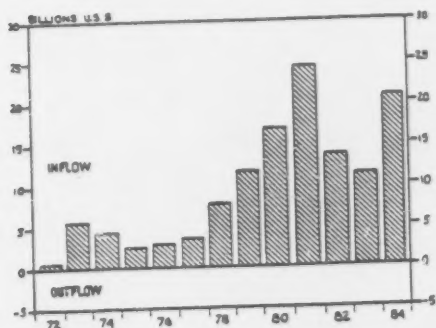
U.S. DIRECT INVESTMENT ABROAD

U.S. DIRECT INVESTMENT OUTFLOWS HAVE FALLEN DRAMATICALLY



FOREIGN DIRECT INVESTMENT IN U.S.

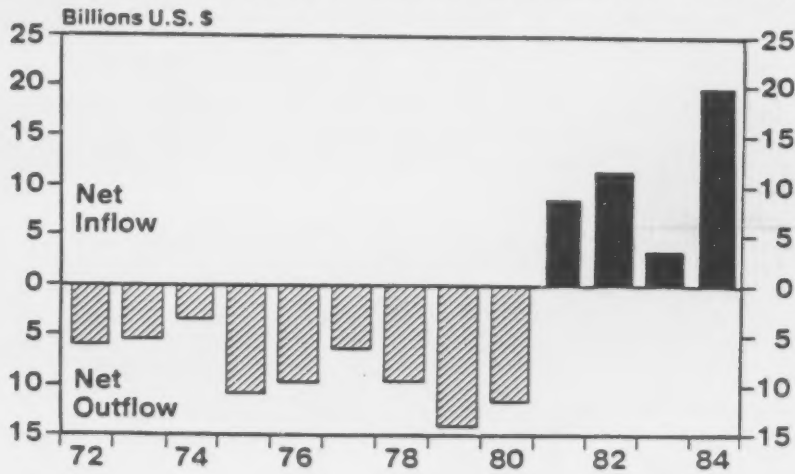
WHILE FOREIGN DIRECT INVESTMENT INFLOWS TO THE U.S. HAVE INCREASED



THE REASON: A MORE FAVORABLE INVESTMENT CLIMATE DUE TO ITC/ACRS

THE COMBINED RESULT HAS BEEN A
SUBSTANTIAL SWING FROM
NET OUTFLOWS TO NET INFLOWS

U.S. NET DIRECT INVESTMENT FLOWS



SINCE 1980, THIS SWING HAS BEEN OVER \$30 BILLION.

of goods consumed or used in the U.S. would be imports, that for a number of years there would be continued job losses in the U.S., and that there would be a substantial long-term productivity loss in the U.S.

Given that more-than-plausible prospect, this critical international dimension must be considered carefully before any repeal or major cutback in ITC and ACRS can be considered.

The international competitiveness issue is more than the issue of where new plants will be built. It is also an issue of whether our plants are sufficiently productive to manufacture goods that can be sold competitively in the world markets. As Professor Summers of Harvard pointed out in a recent address to the Tax Section of the American Bar Association, one way to demonstrate the importance of increased investment on productivity growth is through international comparisons. Professor Summers cited figures for the 1970-1980 period:

TABLE 7

<u>Country</u>	<u>Net Investment As Percentage of GNP</u>	<u>Increase in Productivity In Manufacturing</u>
United States	6.6%	2.5%
France	12.2%	4.8%
West Germany	11.8%	4.9%
Japan	19.5%	7.4%

The relationship between investment and productivity must be given careful consideration before ACRS and ITC are repealed.

**B. Who Will Be Hurt? Capital Is Mobile,
But Jobs, Families and Towns Are Not**

Capital is mobile internationally. A U.S. owner of capital can invest that capital in, say, Akron, Ohio, or he can invest abroad. Solely in economic terms he should be indifferent as to whether he invests in Akron, Ohio, or abroad, so long as he gets the highest rate of return on his capital. But, the people of Akron, Ohio, are certainly not indifferent.

Thus, the issue about repeal of ITC and ACRS is not a "capital" issue, but is instead a jobs and people issue. Capital is mobile, but jobs, families and towns are not.

**C. Jobs, the Quantity of Jobs and the Overall
Structure and Productivity of the U.S. Economy**

The Administration's tax proposal implies two major shifts in investment and ultimately jobs. The proposal acknowledges and apparently intends a substantial shift away from the basic manufacturing sector and into the services sector. The other -- not acknowledged -- is the shift in direct investment from manufacturing operations here to manufacturing abroad.

There should be no question that repeal of ITC and ACRS will reduce investment in the capital equipment sector and cause a loss of jobs in manufacturing and related industries. The commonly used rule of thumb says that for every loss of \$1 billion in investment, there is a corresponding loss of 50,000 jobs. Thus, for example, a \$30 billion loss in investment in the capital-intensive sector implies a loss of 1.5 million jobs. Some of this corresponding loss may occur in the high technology fields because capital-intensive companies are the largest consumers of technologically advanced equipment.

In the long run, jobs lost in manufacturing will tend to be absorbed in the service sector of the economy. The transition, however, is slow and painful. Moreover, this shift in the composition of employment would be very costly to the economy. Wages in the service sector, on average, are considerably lower than in manufacturing. A substitution of service jobs for manufacturing jobs will result in a lower average wage level for the economy as a whole. In addition, the transition will create "structural" unemployment, which is costly in terms of lost income, tax revenues, and outlays for unemployment compensation.

Although services have been growing in importance in the American economy throughout the postwar decades, this has been a gradual process which has allowed time for adjustments to take place. The sweeping changes that have occurred since 1980 have already imposed extraordinary adjustments on the industrial sector. With the removal of ITC/ACRS, the shift from manufacturing to services would be accelerated, possibly to the point where the adjustment mechanisms would become overloaded, particularly in the industrial regions of the country. A strong industrial sector is a necessary element for a growing economy. For these reasons, repeal of ITC/ACRS would do long-run structural damage to the economy.

D. Reduced Cash Flow: Pressure On Financial Markets and Interest Rates

Repeal of the ITC and ACRS would eliminate an important source of internal cash flow for companies and of "gross private savings" in the overall economy, both of which have kept pressure off financial markets and interest rates. Even with reduced tax rates, the large shortfall in corporate cash flow resulting from repeal of the ITC and ACRS and the proposed retroactive recapture tax on prior depreciation would have to be made up in large part by increased borrowing, unless investment is substantially curtailed.

This increased borrowing and the absence of any substantial savings incentives in the Administration's proposal will help drive interest rates up. We may reach a new equilibrium with higher interest rates and less investment.

An increase in interest rates has a circular and corresponding effect on the cost of capital equipment under the Administration's proposal. CCRS is premised on the assumption that corporations will make up the difference in the reduced cash flows by borrowing. The present value calculation by which CCRS can be said to be within 10% of present law assumes a real borrowing cost of 4%. To the extent interest rates go up, the disparity between CCRS and present law becomes even greater.

IV. Overall Conclusion: Why Change Course Now?

Apart from some theoretical notions of tax reform, many of which do not hold up on close analysis, the Administration has not made a case for repeal of the ITC and ACRS.

The true rationale for eliminating the ITC and ACRS and replacing it with CCRS is not tax reform, but is to obtain short-term revenue gains to fund rate reduction. In fact, in FY 1986-FY 1990, the revenue gains (projected by Treasury at current tax rates) from replacing ACRS/ITC with CCRS and placing a penalty tax on prior depreciation total 62% of the revenue cost of lowering tax rates on the proposed tax base.

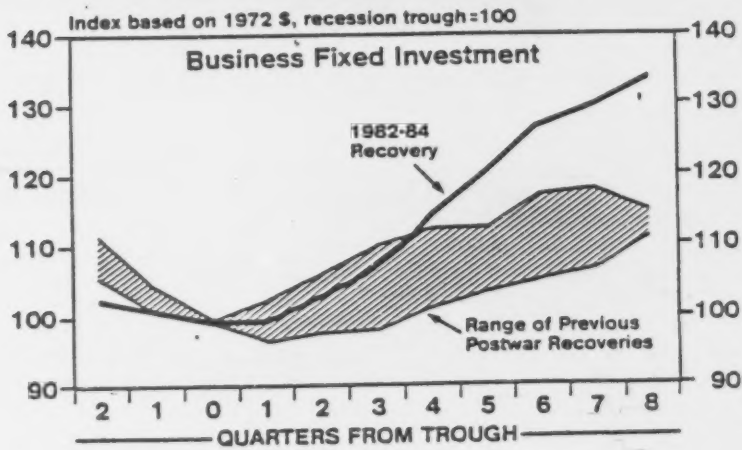
The ITC and ACRS are continuing to work. As the President's budget states, partly as a result of the 1981 increases in depreciation allowances, "over the past two years, real gross nonresidential fixed investment increased at a 15.4% annual rate compared with an average increase of less than 7% in previous cycles between 1950 and 1980." Business fixed investment has been a major factor in the economic recovery since the third quarter of 1982. A stable and predictable capital cost recovery system such as we have had since 1981 is most conducive to long-term steady growth in capital spending.

From the trough of the last recession through the end of 1984, real business fixed investment has increased by 33%. No other recovery has had investment growth over a comparable period that exceeded 15%. This surge in business investment has become one of the sustaining forces in the present U.S. economic recovery.*/

Despite the obvious record of success to date, our economic recovery is still not complete, nor is it uniform in all areas of the country. In 17 states, concentrated in the industrial Midwest, employment has not yet returned to the levels that prevailed in late 1979. In the manufacturing sector, which would be hardest hit by repeal of the ITC and ACRS, employment remains

*/ The source of this material in the next few pages is the Hodes and Maurer paper cited above.

INVESTMENT IN THE CURRENT RECOVERY IS FAR ABOVE THE PATTERN OF PREVIOUS RECOVERIES



THE \$30 BILLION SWING IN DIRECT INVESTMENT INFLOWS
ACCOUNTED FOR 28% OF THE GROWTH IN U.S. INVESTMENT
IN THE CURRENT RECOVERY

below 1979 levels in 41 states encompassing nearly all regions of the country.*/

*/ This discussion and the discussion in the following paragraphs are based on 1984 information available as of June 1, 1985. I understand that more recent data may soon (continued)

Moreover, industrial production is still below 1979 levels in more than twenty basic industries.

Industries That Have Not Yet Recovered Fully From 1981-82 Recession

Mining
Nonferrous Metals
Iron and Steel
Farm Equipment
Transportation Equipment
Petroleum Refining
Leather
Clay, Glass, Stone
Fertilizer
Hardware
Machine Tools
Agriculture, Forestry

Railroad Facilities
Utility Facilities
Construction
Textile Mill Products
Building Paper & Board Mills
Organic & Inorganic Chemicals
Synthetic Rubber
Metal Samplings
Construction Machinery
Industrial Trucks & Tractors
Rolling Mill Products
Electric Lamps

There are compelling reasons, in my view, not to repeal the ITC and ACRS. Further, I have not seen to date any credible justification for repealing these important provisions. Rate reduction is desirable, but again to return to my original thesis -- of even greater consequences is the need for balance between the good to be achieved by rate reduction and the risk incurred from paying for that rate reduction by turning back the clock and retrogressing substantially on capital cost recovery in the U.S. Before it drastically cuts back on capital cost recovery, the Committee should be very sure that the benefits of any particular degree of rate reduction will outweigh tax losses -- with the primary standard being jobs, families and towns, as well as the overall structure and productivity of the U.S. economy in both the short and long term.

Otherwise, the Committee should reject the Administration's proposed repeal of ITC and ACRS along with the retroactive so-called recapture of prior depreciation. There clearly are no other grounds for such a drastic step. I assure you that CCRS is

be finalized. It does not appear that these new data would change the basic thrust of points that I am making.

not an inherently better or more theoretically correct capital cost recovery system than present law. In many respects CCRS is an inferior system.

Arguments to the effect that cost recovery allowances should be reduced because so-called "smokestack industries" do not pay tax or that they have drastically lower so-called "effective tax rates" should be examined very carefully and, in my view, rejected. Smokestack industries pay corporate income taxes, the employer's share of federal unemployment taxes, the employer's share of Social Security or railroad retirement taxes, state and local income taxes, state and local property taxes, and federal excise taxes. These taxes, and other non-tax subsidies provided to state and local governments, constitute a substantial share of a corporation's income. In addition, corporations pay foreign taxes and "royalties" to foreign governments.

There are profitable smokestack companies that pay little current corporate income taxes. But many of these companies have suffered losses in prior years and are merely carrying the losses forward. In other cases, the companies have spent substantial amounts of money in recent years to modernize their plants and open new ones. From a cash flow perspective, they have no profits, although they may have book income.

To attempt to increase taxes on these companies merely because some studies show that they have low effective corporate income taxes would be a major mistake. In a recent American Enterprise Institute working paper, Professor Fullerton of the University of Virginia and Professor Lyon of Princeton could find no systematic difference between the marginal effective tax rates in the high technology sector and the marginal effective tax rates in the more traditional or "smokestack" sector.

Many of the claims that capital intensive corporations have low effective tax rates or pay no income tax are fueled by several over-publicized studies relating to average effective tax rates of corporations in the 1981-1983 period. Let me point out some problems with those studies.

The 1981 Tax Act (ERTA) added ACRS, which provided for more accelerated cost recovery deductions than under prior law. The overlapping of ACRS with a slower cost recovery system necessarily resulted in more allowable depreciation deductions in 1981-1983 than would have been allowable if ACRS has been instituted ten years earlier -- just as the enactment of CCRS would result in significantly fewer cost recovery deductions in the period 1987-1990 than it would if CCRS has been instituted ten years ago. The more than normal amount of depreciation claimed by taxpayers in 1981 through 1983 is a temporary phenomenon that terminates when the cost of pre-ACRS property has been recovered.

ERTA also added safe harbor leasing, which facilitated the transfer of tax benefits from corporations with no current tax

liability to corporations with tax liability. Several large corporations used safe harbor leases to eliminate all or nearly all of their tax liability. The safe harbor lease provisions were repealed in 1982, and almost all safe harbor activity terminated by the end of 1983.

The 1984 Tax Reform Act eliminated another common mechanism through which corporations were able to substantially reduce their tax liability in 1981 through 1983 -- leasing to entities which were not subject to U.S. taxation.

The preceding factors, as well as certain unusual characteristics of the 1981 to 1983 period, make that period a bad period for effective tax rate studies that may be used to support changes in tax law.

There are also a number of theoretical and technical errors in some of the studies. In particular, the frequently-cited Citizens for Tax Justice Study reduces the taxes paid (or increases the refunds received) of safe harbor lessee companies that sold their tax benefits to safe harbor lessors. The study makes no adjustments in the taxes paid by the safe harbor lessors, so that an amount equal to the cash transferred is, in effect, treated as tax savings of both the lessor and the lessee. As a consequence, the study concludes that certain taxpayers that actually paid federal income taxes did not pay any income tax, and it significantly understates the effective tax rates of other companies.

The average effective tax rate studies assume that book income reflects economic income, but in many ways book income is a poor proxy for economic income. Some corporations use accelerated depreciation for purposes of computing book income, while others use straight line depreciation over long lives. Some corporations treat the ITC as an item of book income, while others do not.

I have available and will be glad to provide you with a study which more completely details some of the problems and deficiencies with some of the major average effective tax rate studies. I am convinced that the Committee should place little reliance on the average effective tax rate studies.

In conclusion, I urge the Committee to move carefully to find the appropriate degree of rate reduction that is best in balance with an appropriate capital cost recovery system in the U.S., and to move gradually, even if that requires some phase-in of rate reduction as well as a somewhat lesser overall degree of rate reduction. Among the biggest defects in the Administration's tax proposal are (i) its precipitous nature, given the degree to which the present tax system is ingrained in society and the economy, and (ii) its rigidity in insisting on a certain degree of rate reduction.

* * *

CUMULATIVE COMPARISON OF COST RECOVERY ALLOWANCES
FOR MACHINERY AND EQUIPMENT IN LEADING
INDUSTRIALIZED COUNTRIES (FIRST FIVE YEARS)

EXCERPT FROM THE STATEMENT OF

ERNEST S. CHRISTIAN, JR.

BEFORE

THE COMMITTEE ON FINANCE

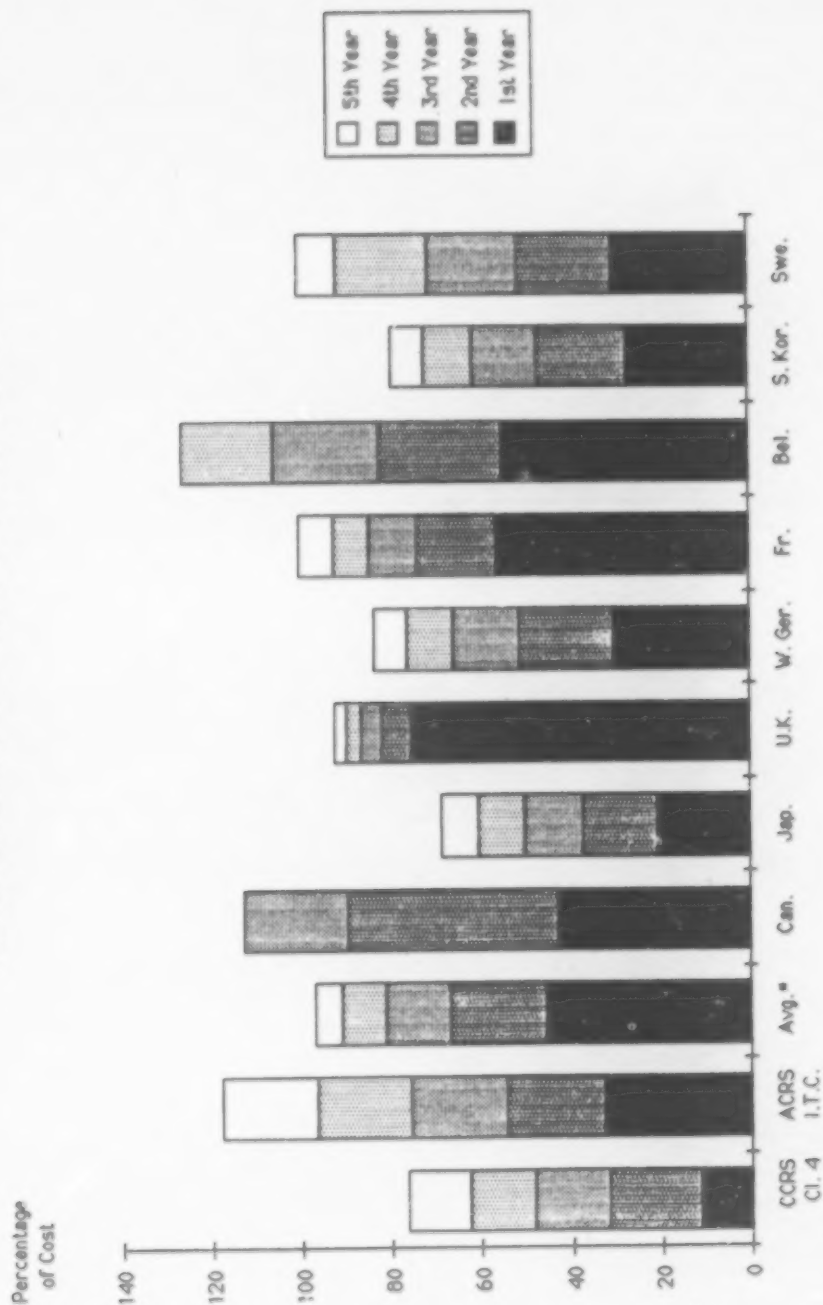
U.S. SENATE

June 20, 1985

The attached bar graph demonstrates that cost recovery deductions allowable under the Administration's proposed Capital Cost Recovery System ("CCRS") for the first few critical years that equipment is in service are significantly less than the deductions allowed by other leading industrialized nations. The graph compares the cost recovery deductions that would be allowed for CCRS Class 4 property placed in service on July 1, 1986 (assuming a steady inflation rate of 5% per year) with the cost recovery deductions allowable for machinery and equipment under current U.S. law and under the laws of other industrialized nations. As illustrated, if CCRS is adopted, the U.S. would rank dead last for cost recovery deductions allowed for most equipment through each of the first three tax years that the equipment is in service.*

*/ The source of the data on other industrialized nations is a recent study prepared by Arthur Andersen and Company. The study converted tax credits to additional cost recovery deductions that would reduce tax liability by the same amount as the credits, and compared U.S. cost recovery deductions with those of 15 industrialized nations. The "average" listed on the bar graph includes all 15 countries (excluding the U.S.).

**Cumulative Comparison of Cost Recovery Allowances
For Machinery and Equipment in Leading
Industrialized Countries (First Five Years)**



CUMULATIVE COMPARISON OF COST RECOVERY ALLOWANCES
FOR MACHINERY AND EQUIPMENT IN LEADING
INDUSTRIALIZED COUNTRIES (FIRST FIVE YEARS)

Countries Included on Bar Chart

<u>Country</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
United States (CCRS Cl. 4)	11.0	31.6	48.4	62.3	76.5
United States (ACRS/ITC)	32.4	54.4	75.4	96.4	117.4
Canada	42.7	89.2	112.5	112.5	112.5
Japan	20.6	37.0	50.0	60.3	68.5
United Kingdom	75.0	81.3	86.0	89.5	92.1
West Germany	30.0	51.0	65.7	76.0	83.2
France	56.0	73.6	84.2	92.1	100.0
Belgium	54.6	81.9	105.7	125.9	125.9
South Korea	27.1	46.8	61.2	71.7	79.4
Sweden	30.0	51.0	71.0	91.0	100.0

Additional Countries

<u>Country</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Denmark	25.0	47.5	63.3	74.3	82.0
Hong Kong	68.5	78.0	84.6	89.2	92.4
Italy	25.0	50.0	75.0	85.0	95.0
Luxembourg	106.9	127.5	139.9	147.3	151.8
Spain	67.9	86.7	100.8	111.3	119.2
Switzerland	30.0	51.0	65.7	76.0	83.2
Taiwan	20.6	37.0	50.0	60.3	68.5
AVERAGE (excluding U.S.)	45.3	66.0	81.0	90.8	96.9

The CHAIRMAN. In this committee, we follow a first-come, first-served rule on questions. Senator Heinz was here first, and the order I have is Heinz, Packwood, Baucus, Bradley. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you. Let me just follow up Ernie Christian's testimony with a question about his multicolored chart. No doubt they are produced on an imported xerox machine.

Mr. CHRISTIAN. They very well could have been, sir.

Senator HEINZ. According to this chart, the CCRS proposal of the administration would—as I have drawn a line across it—leave the United States at a clear capital cost recovery disadvantage versus every country on this chart, except, interestingly, Japan. I have two questions. One is, leaving Japan aside for the moment, is it the clear implication of your testimony that this chart in effect proves that we will be at some kind of international competitive disadvantage in the manufacturing sector? And second, what does it mean that Japan, which apparently has at least over a 5-year period a lower capital cost recovery rate than would be provided—what is the significance of that?

Mr. CHRISTIAN. Senator, as far as the first question, by this comparison—which is one of several, but I do believe the most relevant—we would have substantially reversed ourselves internationally and would be at a very substantial disadvantage. Insofar as Japan is concerned, I do not have any personal experience. From secondary sources, I believe there is an explanation. In Japan, interest rates are a great deal lower than here—I understand about 6 percent. It is also the case that there is a formalized working relationship between the banking system, manufacturers, and the government for capital allocation.

Senator HEINZ. Since my time is short, let me summarize what you are saying, namely that the Japanese have a much lower cost of capital than anybody else. Is that what you are saying?

Mr. CHRISTIAN. Overall that is the result.

Senator HEINZ. Yes. Because my time is limited—

Senator BRADLEY. Mr. Chairman, are we on the free-for-all basis again, or is this—

The CHAIRMAN. No, we are not on a free-for-all basis today. That is only in basketball. [Laughter]

Senator HEINZ. Let me just ask the other three witnesses for a brief reply to question No. 1 Mr. Christian has answered my first question in the affirmative, that is, that in effect CCRS—notwithstanding the indexation of the base—puts our country at a disadvantage with every country, and leaving Japan aside. Do you agree, Dr. Prakken?

Dr. PRAKKEN. Yes.

Senator HEINZ. I am looking for a yes or no answer. Yes or no or maybe?

Dr. PRAKKEN. I am going to say maybe.

Senator HEINZ. Dr. Auerbach? Yes, no, or maybe?

Dr. AUERBACH. No. And as I stated in my testimony, I could not find any evidence that the cost of capital is lower in Japan than it is in the United States.

The CHAIRMAN. I'm sorry. I didn't hear what you said.

Dr. AUERBACH. As I detailed in my written testimony, I have just completed an empirical study of corporations in Japan and in the

United States and found no evidence to support the conclusion that the cost of capital is lower in Japan than it is in the United States.

Senator HEINZ. Dr. Fullerton.

Dr. FULLERTON. No, and recent research of a number of countries—

Senator HEINZ. Let me get to the second question because I am about out of time.

Senator BRADLEY. That is 3 to 1.

Senator HEINZ. We had a group of business firms here last week, and they all indicated that they had some concerns about CCRS, some biases toward structures and away from equipment, the ITC problem, if you will. They indicated concern about the windfall tax. But when I asked them how do you want us to solve those problems? Should we take some of the corporate tax burden—I guess you have a 9-percent increase in your overall taxes here—should we shift that onto individuals? They said no. Yet, each of you, one way or another, has identified some problems with what is being proposed here. My question is that, to the extent that the elimination of the ITC is a problem or that the windfall tax is a bad principle, what or how would you propose to address it without shifting corporate taxes onto someone else? Is there an inherently better way of taxing corporations that doesn't increase the cost of capital, doesn't discourage investment, in some sense does a better job of maximizing the availability, and the time of their cash flow than what is proposed here. Dr. Fullerton, I will start at your end?

Dr. FULLERTON. Estimates in my testimony suggest that the total taxes in the corporate sector are not any higher than they would be under current law.

Senator HEINZ. All right. So, we count you out of this discussion. Dr. Auerbach.

Dr. AUERBACH. I think you can count me out, too, because, as I detail in my testimony, by 1990 investment-oriented corporate taxes will probably be lower than they would be under current law.

Senator HEINZ. How about in the next 5 years?

Dr. AUERBACH. I think the only difference in the next 5 years is the windfall tax, which I don't see as having a major effect on investment.

Senator HEINZ. Dr. Prakken.

Dr. PRAKKEN. Let me suggest two possibilities. Our estimates suggest, in terms of impacts on capital formation and the cost of capital, that if the investment tax credit was maintained and the corporate tax rate raised to offset the revenue loss, that it would be possible to have a reform that did not significantly increase the cost of equipment. Another possibility which would slightly raise the cost of equipment would be to allow total first-year expensing of all kinds of capital, no investment tax credit, but in order to keep the system economically neutral, you would also have to prohibit interest deduction.

Senator HEINZ. Mr. Christian.

Mr. CHRISTIAN. I don't see how they conclude that there is not a huge increase in tax on capital. There is a huge increase in tax on corporations, according to Treasury's figures—\$118 billion over 5 years.

Senator HEINZ. My question is: The corporations have said they don't mind paying taxes. They just don't like the way the taxes are being levied. What would be a better way of doing it?

Mr. CHRISTIAN. There might be some adjustment in the degree of rate reduction, both for individuals and corporations. There might be some supplemental revenue source. It is obvious to everyone that the administration's tax bill is already under water from a revenue standpoint. It is not revenue neutral, as proposed by the administration. There might be other supplemental revenue sources outside the income tax which could in a total package, provide a more rational result.

Senator HEINZ. Thank you, Mr. Chairman.

The CHAIRMAN. Gentlemen, let me pose a hypothetical. More and more, and I will preface it by saying this, we are hearing the argument that we have got to change our capital formation rules because our foreign competitors have changed theirs, and we are operating in the international marketplace, and there are factors there that are beyond our control. And therefore, keep the investment tax credit. Therefore, allow us to expense all investments, or however you want to do it. I want to go back first to a situation where, presuming we have no foreign competition—and that is not unlike what the automobile had in the late 1940's, 1950's, and 1960's. It wasn't until the 1970's that we started getting deep penetration. If you had no foreign competition, and assume a normal, acceptable rate of inflation, and you had only useful life depreciation, would it make any difference in the attraction of capital whether you were a capital intensive industry or not? Or would you get it in any event and you would simply have to increase the cost of your product to account for the fact that you had to have more capital than a less capital-intensive industry? Let me start with Ernie, but let me make it more specific. You know, right now you have a lot of wholesale and retail trade businesses supporting this bill. They are not heavily capital intensive, and they think they will come out better. Given the assumption I had of no foreign competition, would you still be able to attract capital to the automobile industry, to the steel industry if you had no foreign competition, or would all of the capital want to fly into less capital-intensive industries where it would take less capital—less investment to get a return on their income?

Mr. CHRISTIAN. I think that is a very likely result, if you put it that way, Mr. Chairman. As I said in my remarks, what happens to a firm depends on the ratio of required capital investment that the firm must make to its degree of profitability.

The CHAIRMAN. But why, though, is it a less likely circumstance? If people are going to drive cars—unless the cost of cars is going to be so great that people are going to buy lots of suits and T-shirts and other things instead of cars, if they are going to buy cars—within reason—what difference does it make what the cost of capital is to the automobile industry, absent foreign competition? Wouldn't you still get roughly the same return on your investment? Granted, you have to charge more for your product because you have to have more accumulated capital, but wouldn't you get roughly the same return?

Mr. CHRISTIAN. I think what you would be experiencing is that you would be using less capital as it became more expensive, and output in total would be less. Prices would also be higher.

The CHAIRMAN. Let me go down the line.

Dr. PRAKKEN. Two comments on that. First, it is undeniably the case that if you raise the cost of capital for heavy industry, that resources will flow from those industries to save the less capital-intensive ones. I would suggest that the authors of reform have exactly that kind of redistribution in mind. And two, what happens when the cost of capital, subsequent to implementation of the reform, depends crucially on what happens to interest rates following implementation. Our estimates are that initially capital costs would rise but, in 6 or 7 years time, they may be even lower. That is, interest rates could be significantly lower later—

The CHAIRMAN. Explain that to me again. I don't understand why the capital leaves the heavily capital-intensive industry if there is a market for the product. I understand elasticity, and I understand you are not going to sell as many cars at \$25,000 as you do at \$10,000.

Dr. PRAKKEN. It is not a question of how many cars you produce. It is how much capital you use to produce a given amount of cars. What will happen is that the auto makers in Detroit will decide to switch to a less capital-intensive means of producing the same number of cars, and the resources will flow elsewhere.

The CHAIRMAN. Wait a minute. They will switch to a less capital-intensive means? There is nothing wrong with that, is there, if they can do it?

Dr. PRAKKEN. Well, if you believe in the fact that we have unduly subsidized makers of cars, then there is nothing wrong with it?

The CHAIRMAN. Have what?

Dr. PRAKKEN. If we have unduly subsidized makers of cars, then there would be nothing wrong with that.

The CHAIRMAN. No. I thought you said they would move to less capital-intensive means of manufacturing the cars.

Dr. PRAKKEN. That is correct.

The CHAIRMAN. How do you do that?

Dr. PRAKKEN. It is difficult to envision the kind of production technology that would evolve from that.

The CHAIRMAN. But it seems to me that if you could figure out a way to do it with less capital—

Dr. PRAKKEN. Oh, they would respond to the price incentives and plus it on the higher cost of capital, and new technology would be forthcoming.

The CHAIRMAN. Let me go down the line.

Dr. AUERBACH. Just to answer that last question: You would build fewer plants and put on more shifts. What would typically happen if you raise the cost of capital would be that the more capital intensive the industry, the more its overall factor costs would go up, the more it would have to pass through the output prices, the more one would expect that industry to contract relative to other industries, and you would expect to see a change in the mix of production, and overall a less use of capital.

The CHAIRMAN. All right. Dr. Fullerton, go ahead.

Dr. FULLERTON. That is basically my view as well. There is some evidence that a viable corporate tax would increase the product prices in the corporate sector and might decrease the overall rate of return, but I would emphasize that the allocation of capital depends upon the incentives to invest at the margin. And while this recapture tax collects revenue and has income effects on corporations, it takes money out of their hands as is needed for revenue, but it really doesn't affect the incentives to make new investment.

The CHAIRMAN. Using the example of the automobile industry again during the 1940's and 1950's and 1960's, and the cost of labor—not the cost of capital—they were all unionized. All of the wages were roughly the same, although they were bargained company by company. All of the health benefits were roughly the same. And it made no difference to the companies what their cost of labor was, so long as they all had the same costs of labor. And they had tremendous sales years on cars. We did not see money flowing into industries that were less labor intensive. They got by somehow. Now, why with disproportionately high labor costs did they get by? Why didn't the money go someplace else? You had to put too much of it in. You had to pay too much for the labor you were getting out of it.

Dr. AUERBACH. If I could venture a guess on answering that, certainly it was not a competitive labor market in the automobile industry—a small number of producers dealing with one union. And certainly, their labor costs were higher than labor in a competitive market, and that undoubtedly led to a lower utilization of labor in the industry than otherwise would have been the case. And it undoubtedly led to higher product prices than would otherwise have been the case.

The CHAIRMAN. But it didn't make any difference so long as they could sell the product.

Dr. AUERBACH. It made a difference. It probably reduced the number of cars that were sold. It probably increased the prices of the cars that were sold. It probably was less of a serious issue without foreign competition because there was less elasticity in the demand for American cars when there were no competitors.

Dr. PRAKKEN. I think we might add that, to the extent that the wage gains garnered in the auto industry during that period of time were in excess of worker productivity, that it is a very real problem now.

The CHAIRMAN. Oh, yes, I understand it is now, but it wasn't so long as they all faced the same situation and no foreign competition.

Mr. CHRISTIAN. Mr. Chairman, just one final comment. I think what is emerging from all this is that, under your hypothesis, seemingly the agreed-upon result is, if I may state it, you are substituting labor for capital, and the long-term result is an archaic industrial plant in the United States.

The CHAIRMAN. Dr. Fullerton.

Dr. FULLERTON. I don't have anything to add.

The CHAIRMAN. All right. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman. I would try to get a little better understanding of why some of you disagree over whether the present tax law results in comparatively higher

United States capital costs than, say, Japan or other countries and why you think that there might be a difference under this proposal. That is, as I understand you, Ernie, you seem to think that the capital costs compared to Japan will be higher if this proposal is passed, and yet I understand that you, Dr. Auerbach and Dr. Fullerton, tend not to agree with that. I don't understand why you disagree. I mean, you are all economists. You look at the same bill and same figures. Why the difference?

Dr. FULLERTON. Shall I start? Actually, I have just been to Japan for a week, studying the tax system, and everything that I learned there tends to indicate that an equity financed investment in Japan would be taxed at least as high as an equity financed investment in the United States, if not higher. A debt financed investment in Japan would also be taxed very similarly to debt financed investment in the United States—maybe a little more subsidy to debt in Japan—but the big difference between the two countries seems to be that the companies in Japan are able to use a lot more of this subsidized debt. And so, the estimates of the overall cost in Japan might be lower because they use more debt, but—

Senator BAUCUS. This is subsidized debt.

Dr. FULLERTON. The interest payments on debt are deducted at a currently high statutory rate of 46 percent in the United States. That subsidy to debt would be reduced by the proposal because the rate would come down to 33 percent. They wouldn't get so much tax break in the way of interest deductions.

Senator BAUCUS. So you are saying, if I understand you, that under the proposal the capital costs in the United States would be higher because of less interest expense to be deducted.

Dr. FULLERTON. It is hard to say why the Japanese firms are able to use more debt, and I don't think that there is really any way to legislate changes that would make the United States tax system more like that of Japan, if they have this working relationship between the banks and the companies. They are able to use more debt. In fact, the President's proposal would probably make the United States tax system more like that of Japan since Japan has no investment tax credit and these relatively slow depreciation allowances. In terms of the statutory provisions, the President's proposal would make the United States tax system look much more like Japan's.

Senator BAUCUS. If I understand you, what you are saying is that because of the relationship between Japanese banks and manufacturing companies and because Japan has lower interest rates, the costs of capital are lower in Japan.

Dr. FULLERTON. Considering that they use more debt.

Senator BAUCUS. It is a consequence not of the Tax Code but rather a consequence of different factors.

Dr. FULLERTON. Yes, and I also should note that that high debt-equity ratio in Japan is currently falling. I think one of the stories I heard was that—and which I believe—is that equity markets were not well developed after the war in Japan, and so they sort of necessarily used more debt. But now that equity markets are developing, firms find that access of capital much more available, and the debt ratio is falling in Japan. So, it is becoming more like the United States.

Senator BAUCUS. Why is it falling?

Dr. FULLERTON. Access to equity markets has been more readily available in Japan. The story was that after the war they were more readily able to use that, so they had a very high ratio of debt to equity.

Senator BAUCUS. As a consequence, are there capital costs going to be more similar?

Dr. FULLERTON. They are becoming more similar over time.

Senator BAUCUS. Why did Japan want to do that? Why did Japan want to increase its capital costs compared to the United States?

Dr. FULLERTON. It is not a conscious decision on the part of the Government, I don't think. It is the institutional practices of the banks and the firms. And as I said, you can't really legislate debt-equity ratios. You could give more of a subsidy to debt by increasing the statutory rate and allowing them to deduct—firms to deduct interest at a higher statutory rate, but I don't think that that is something we want to do in order to imitate Japan's high debt-equity ratio.

Senator BAUCUS. I am not asking you what we want to do. I am asking why it would be in Japan's best interests to allow themselves to be in a lower—

Dr. FULLERTON. There are other offsetting costs of debt.

Senator BAUCUS. Thank you. I want to ask another question. Ernie, would you agree that the reason, as Dr. Fullerton has stated, Japan has lower capital costs is because of lower interest rates and maybe arrangements between banks and manufacturing companies? That is, the reasons have nothing to do with different tax treatment.

Mr. CHRISTIAN. I think that is right, Senator. The point is the tax effect of the cost recovery system in Japan is far less relevant than it is here because that is not such a principal source of cash flow for investment. It is otherwise provided for in their economy.

Senator BAUCUS. It is a consequence as to what degree should we use the Tax Code to try to level the playing field. I think if the reasons why Japan has lower capital costs are reasons that have not that much to do with different tax treatment, then the next question that comes to my mind is that if we want comparable capital costs, that is roughly the same as Japan, do we change the Eagle Act? Do we legislate lower interest rates? Do we lower the deficit by \$100 billion this year? Do we give a directive to the Fed, or, in addition to all that, do we use the Tax Code to try to lower capital costs? That is, to what degree should we use the Tax Code to level the playing field in your judgment?

Mr. CHRISTIAN. I think that we—

Senator BAUCUS. As opposed to other measures we could take to lower the playing field?

Mr. CHRISTIAN. I think what we should have is a Tax Code that is neutral with respect to capital cost recovery. Our present system of the ITC and ACRS is close. What we should not do is cut back on capital recovery in the United States relative to Japan.

Senator BAUCUS. I'm sorry? We should not cut back on?

Mr. CHRISTIAN. We should not cut back on capital recovery as the administration is proposing to do. That certainly is not leveling

the playing field. We are close to being level now because we have the ITC and ACRS.

Senator BAUCUS. So, you are saying that, yes, we should use the code to level it?

Mr. CHRISTIAN. Yes.

Senator BAUCUS. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman. I would like to ask the panel to really kind of take off the gloves at this point. [Laughter.]

I mean, I think you are being much too polite about each other's points of view. There is a great difference in points of view on the panel, and I would encourage maybe one or two of you—at a later point, I will identify which—to do battle right there. Now, let's have a real debate. I mean, we have some information, but each of you have taken contrary points of view and each of you purports to have an analytical basis from which to make those points. Therefore, I would like to read from Dr. Auerbach's testimony. He says: "There is a view held by many that the current problem facing U.S. firms in their economic battle with foreign counterparts, notably Japan, is the relatively heavy burden of capital taxation in the United States. I am aware of no evidence to support this proposition." No evidence. "Nor is there convincing evidence that other factors give Japanese firms a lower cost of capital." Now, Mr. Christian, here is a beautiful chart.

Mr. CHRISTIAN. Thank you, sir.

Senator BRADLEY. It shows that there is a lower cost of capital for Japanese firms than U.S. firms. So, tell me: Why do you disagree with Dr. Auerbach? Give us the reasons; what is your analytical basis. And Dr. Auerbach, feel free to intervene and refute. Mr. Christian.

Mr. CHRISTIAN. What the chart is showing is the cumulative capital cost recovery deductions allowed by Japan in years 1, 2, 3, 4, and 5. Those total 68.5 percent of equipment costs. Under the administration's proposal, the total cost recovery deductions over 5 years would be 76.5 percent. By that comparison, the cost of capital is a little bit greater in Japan than it would be in the United States if the administration's proposal were enacted. The cost of capital in the United States right now is, by this comparison, greatly less. Presently, the cost of capital—the recovery level in the United States over 5 years—is very substantially less than in Japan.

Senator BRADLEY. You mean under ACRS?

Mr. CHRISTIAN. ACRS-ITC.

Senator BRADLEY. Well, you have restated the chart. What is the analytical basis for that?

Mr. CHRISTIAN. These bars are based on data that were assembled by Arthur Andersen about the international tax systems. We then simply calculated the dollar amounts of recovery per year, based on their synopses of the international systems and produced this result.

Senator BRADLEY. OK. You have restated the footnote. Dr. Auerbach, what is your opinion, or you can summarize—

Dr. AUERBACH. I have an opinion of the table, but I would also like to answer your question. I mean, I think that the table looks at the first 5 years, and people have criticized business schools for encouraging shortsightedness among executives, and I think we should now extend the criticism to accounting firms. [Laughter.]

But on the issue of the cost of capital in Japan, I don't think there is any disagreement that the capital income taxes are heavier in Japan. The only disagreement is over whether there are other factors that cause the cost of capital to be less in Japan despite the tax disadvantages faced by investors. And the study that I cited in my testimony was actually one that looked at the returns and the costs of various large American and Japanese firms. It found that indeed there was more use of relatively inexpensive debt in Japan, but there was an offsetting higher cost of equity, as one would expect, for firms that borrow more heavily, and overall there was really no evidence to suggest that Japanese firms had a lower cost of capital. Research in this area is still fairly embryonic at this point, but I stand by my statement that I don't know of any evidence to the contrary.

Senator BRADLEY. Do you know of any evidence, Mr. Christian?

Mr. CHRISTIAN. Not in the context in which Dr. Auerbach is talking.

Senator BRADLEY. So, you don't know of any evidence either that would assert that the cost of capital in Japan would be lower, which seems to me to be contrary to your chart.

Mr. CHRISTIAN. No, sir, that is not what I am saying. I am saying that the cumulative deductions or deduction equivalents allowed in the first 5 years under the Japanese system is 68.5 percent of cost.

The CHAIRMAN. Now, wait. I think they are talking about different things. You are talking about just the depreciable allowance on equipment.

Mr. CHRISTIAN. That is all this chart is purported to—

The CHAIRMAN. But that is not what Dr. Auerbach is talking about. He is talking about the whole cost of capital, as I understand it.

Mr. CHRISTIAN. That is what I am trying to address. I believe the point of this is that the cash recovery—the internal cash flow—produced by whatever your depreciation system is, is a much more important factor in our system than it is in Japan because in Japan, by other means, capital is allocated to various uses. whereas here cash flow is very important.

Senator BRADLEY. Do you agree with that, Dr. Auerbach?

Dr. AUERBACH. I agree with that point. The tax system bears more heavily in Japan on capital investments that it does here.

Senator BRADLEY. It bears more heavily in Japan?

Dr. AUERBACH. Right.

Senator BRADLEY. Is that the point you made, Mr. Christian, that the tax system bears more heavily in Japan? I thought your point was that it bears more heavily in the United States.

Mr. CHRISTIAN. Under present law, a lesser amount of recovery of costs occurs in Japan in the first 5 years, which means that under present law the United States with ITC-ACRS has a more favorable cost recovery system than does Japan.

The CHAIRMAN. But, Bill, they are talking about apples and oranges, aren't they?

Senator BRADLEY. It sounds to me like they are saying the opposite.

The CHAIRMAN. It sounds to me like Ernie is talking about the depreciable cost of equipment. That is not how much does it cost to borrow money, not the corporate tax rates or anything that may go into a total assessment of how much does it cost for capital.

Dr. AUERBACH. I don't think there is any disagreement about what is in the chart. I think there is disagreement about what is not in the chart.

Senator BRADLEY. So, Mr. Christian is simply saying if we just take depreciable assets and ignore other relevant factors, then the overall cost of capital then—the comparisons are as the chart reveals.

The CHAIRMAN. For the first 5 years.

Mr. CHRISTIAN. Correct.

Senator BRADLEY. For the first 5 years?

Mr. CHRISTIAN. Correct.

Dr. AUERBACH. But just that factor of the cost of capital gives the United States an advantage—a lower cost.

Senator BRADLEY. It shows the United States has a lower cost, even with this?

Dr. AUERBACH. Right.

Dr. FULLERTON. To clarify a little further, the chart shows the cost recovery. It is lower in Japan by this chart, meaning the cost of capital is higher for this equipment, and this is an important part, but only part of the cost of capital. Besides Dr. Auerbach's study, I have seen another study for Japan, which measures cost of capital and effective tax rates in a way strictly comparable to a book that I worked on for four other industrialized countries, and it finds that for equity, Japan would be taxed higher than in the United States. For debt, it would be taxed slightly lower than in the United States, but overall the advantage to Japanese firms is only in their higher use of the lower tax debt—a debt-equity ratio that is falling over time.

Senator BRADLEY. Mr. Chairman, could I just do one quick thing?

The CHAIRMAN. One quick one.

Senator BRADLEY. Why do you make the point, Dr. Auerbach, that to look at this in a 5-year time frame is inadequate?

Dr. AUERBACH. First of all, that choice of a timeframe will bias the results very much in favor of the current system because of its speeded-up capital recovery. When we go to an indexed depreciation system—where in the present of inflation, a large fraction of the value of depreciation deductions is received in later years—businesses should take present values into account. This isn't a risky investment unless you believe the Government is going to default. Looking at the first 5 years for many of these assets which will be receiving deductions over many years with much greater value because they are indexed is very misleading.

Mr. CHRISTIAN. I would have to disagree with that strongly. We may have a little argument because what I have been trying to illustrate here is the cash-flow effect. It is true that the administration's proposal is back loaded, as I said in my statement, by means

of the inflation adjustment. I don't believe that inflation adjustment will, in fact, stick around very long. Without it, the administration's proposal is disaster, even on a present value basis. You don't buy equipment with present values; companies will have to borrow a great deal more. That is one of the purposes to be shown by this chart, which is related to cash. If firms borrow more, their borrowing costs will go up.

Dr. PRAKKE. I think we might point out here that if there is a cash-flow hit up front because of the change in the depreciation rules, that also means there will be more cash-flow later on. And that is why the present value calculation is so important.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. Mr. Christian, looking at your chart, I would say that paradise would be the United Kingdom. But there is nothing that indicates, as a practical matter, looking at the result that such is true. Could you explain why the United Kingdom hasn't done better in what is, in effect, nearly expensing of their capital equipment?

Mr. CHRISTIAN. I understand why you are asking the question, Senator. I don't suggest that having an expensing system, which the United Kingdom is close to doing, is the solution to all problems that a country or an economy may have. As in the case of Japan, our system right now is better than theirs, by this comparison. We are having trouble competing with them. I would hate to have to compete with them if ours were worse than theirs.

Senator CHAFEE. But what these charts seem to show is that all of this is perhaps important, but there are a host of other factors that are more important.

Mr. CHRISTIAN. There are certainly a host of other factors. In many cases they are more important than taxes.

Senator CHAFEE. I mean, the British have practically been expensing their equipment. Second, nobody is wringing their hands over the strength of the pound, and yet, they have got all kinds of problems. I guess the result of what your chart shows me is that what we are debating here isn't everything by a long shot.

Mr. CHRISTIAN. That is certainly true, but the only purpose was to give the committee the information that we would be essentially last by international comparison computed in this way, which I believe is the most relevant way.

Senator CHAFEE. What would the chart look like if it were extended to the ninth year, for example?

Mr. CHRISTIAN. What you will see there is that most of these columns at the top of the fifth year are getting rather close to 100. I think we have some data on that, Senator Chafee, which I am trying to look up. But the point is that 5 or 6 or 7 years is about the horizon for most of these countries.

Senator CHAFEE. I think you are probably right, and I am not going to press that. It seems to me that many of the industries we have a concern for, the high tech—and others, that their equipment is obsolete after 5 years. This gives a pretty good indication of what it does to those industries, anyway.

Mr. CHRISTIAN. That is right.

Senator CHAFEE. Professor Auerbach, on page 5 of your statement, you talk about under the new system—in the middle of the

page there: "The effective corporate tax rate on depreciable assets would be reduced to a small extent, with equipment facing a higher tax rate and structures facing a lower tax rate than under present law." That concerns me. Do you see any concern there yourself? In other words, I would like to skew this around so that the equipment would face a lower tax rate. The structures I am not so worried about. Do you see a difference?

Dr. AUERBACH. Well, first of all, equipment now does face a lower tax rate, and what would happen is the relative changes would be from a current system where equipment is very heavily favored relative to structures. And my view is that when people think about structures, they often think about real estate, commercial buildings, and apartment buildings, but there are also a lot of industrial buildings. And they are the primary kinds of buildings to which the corporate tax applies. If one wants to continue talking about Japan, you can talk about the very modern Japanese steel mills that have been built in recent years. I don't see any reason why we should favor the equipment put into steel mills relative to the mills themselves. We currently do that, and many industries that use structures more intensively than equipment are disadvantaged at the present time.

Senator CHAFEE. I see. I guess you have all given me food for thought here because we get so tangled up around this place on depreciation schedules, and we forget that there are lots of other factors involved, particularly if the rates are coming down. It seems to me that the rates coming down, that is a terribly important factor.

The CHAIRMAN. It is or it isn't?

Senator CHAFEE. It is. It is an important factor. If you are going from 46 down to 33, there is a big difference. I am for the accelerated depreciation. I am sorry that I missed your testimony Professor Auerbach, you don't have any trouble with dropping the ITC.

Dr. AUERBACH. It would be nice to have it if it came for free.

Senator CHAFEE. If it came what?

Dr. AUERBACH. If it was free, it would be nice to have, but it is a substantial revenue drain; that is obviously part of the overall picture. It would be impossible to maintain any kind of revenue neutrality or to be even close if we put the investment credit back in and still bring the rates down. It just wouldn't be possible.

Senator CHAFEE. What do you say to that, Dr. Fullerton?

Dr. FULLERTON. Some of the effective tax rates that Dr. Auerbach refers to in his testimony actually appear in the figures at the end of my testimony. The first figure shows how equipment is subsidized because of the combination of investment tax credits, accelerated depreciation, and interest deductions. And it is not clear why, if the corporate tax was originally intended to be collecting revenue, why it should be doling out revenue on behalf of equipment.

Senator CHAFEE. Mr. Christian's chart would seem to suggest that also, that we are subsidizing. If you get 117 percent recovery in 5 years, that is doing pretty well.

Dr. FULLERTON. And that is just for the depreciation allowance. With the combination of the interest deduction, the subsidy can be even larger.

Senator CHAFEE. Thank you.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. I find this very interesting. I wish I had been here for all of it. Let me understand this, Mr. Christian, on this chart of yours. I assume you have factored in some discount to determine the present value on money, or have you not?

Mr. CHRISTIAN. No, sir.

Senator BENTSEN. To show the relative importance of first and second years related to debt.

Mr. CHRISTIAN. What this is, Senator Bentsen, is simply a chart showing the amount of cost recovery deductions assuming \$100 of equipment costs, for example.

Senator BENTSEN. So, the value of money has not been factored in?

Mr. CHRISTIAN. This does not involve a tax rate, nor is it a discounted present value table. It simply shows the cash recovery or the deductions allowed per year for the first 5 years under the various systems.

Senator BENTSEN. I find this extremely interesting. I wonder if any of you have looked at the report of the American Business Conference on the cost of capital as compared with Japan—Dr. Auerbach, I see you have. That is Dr. George—

Dr. AUERBACH. Hotsopoulos.

Senator BENTSEN. All right. Thank you for helping me on that. Tell me what you think of that, and obviously, you must disagree with it.

Dr. AUERBACH. That study has its primary focus, the cost of capital in the United States. I don't think my major disagreement is with its conclusions about the United States. It devotes much less space to the study of the cost of capital in Japan. I think it is forced to make many more assumptions because of the lack of information. That is where my major disagreement is. I just don't find that—

Senator BENTSEN. Now, have you really made quite an extensive study of the cost of capital in Japan? I wasn't here when you testified.

Dr. AUERBACH. It is certainly more extensive than is contained in that study, and I don't mean any insult to its author in saying that. What we did was to look at a large number of major corporations in the two countries. We made various corrections to book values to account for different institutions in the two countries. We tried to ascertain what the costs of debt and equity were and factored in the effects of inflation and taxes. And what we found was that high debt-equity ratios in Japan have been overstated.

Senator BENTSEN. You mean the idea that the ratio is 3 to 1 in our country and 1 to 3 in theirs—

Dr. AUERBACH. The results for our country, as I said, don't differ very much. With the results in Japan, it is probably more accurately 1 to 1. And this is historically. Dr. Fullerton referred to the trends. My numbers are historical. It may be even lower than 1 to 1 right now. We also found that the relative cost of debt is lower in Japan, as it is lower here. The cost of equity in Japan is higher than the cost of equity is in the United States, as one would expect for companies which have a greater degree of borrowing in their capital structure. Overall, if you took the names off the countries and you just looked at the data, you wouldn't be able to identify

one country as having a lower cost of capital than another. So, from that, I conclude that there is no convincing evidence that the cost of capital is lower in Japan, which is not to say that it is certainly not lower. I think more evidence could be adduced on the question, but as yet, I don't think anyone should conclude that the cost of capital is lower in Japan, let alone legislate on the basis of that conclusion.

Senator BENTSEN. You know, Doctor, if we were insulated and isolated in this Nation of ours, then I would go with this idea that there should be no incentives built in for one sector or another. It ought to be absolutely level. But obviously, we are not. And that is why it is terribly important what we are discussing here, it seems to me. I am one who is very much concerned about the erosion of the manufacturing base in this country, and it is not just the cost of capital. And it is not just the depreciation schedule, as I am sure you stated. It is a whole myriad of things—the difference between the dollar and the yen and all the rest of those—whatever it may be. So, I think that this is a most interesting and productive discussion. I appreciate it. I will be going back and reading your testimony. Thank you.

The CHAIRMAN. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman. I regret that, due to a prior commitment, I missed the presentations. I have concern about the administration's proposal—and there is much in it that I like and admire—but I am concerned, as I said when Jim Baker was before us, about two aspects of the problem. One is its impact on the cost of capital to business, whether we are doing what is necessary to help create what I call an environment of growth. And the other is that it does appear to land pretty heavily on middle-class taxpayers. Now, if we were going to correct this problem—as I say, the first problem is the cost of capital—it would cause a large revenue drain. And the same is true that if we were going to reform the proposal to give a better break to middle-class America. Mr. Christian, I would like to ask you: Would you support a broad-based tax, such as my BTT, to make up revenue shortfalls caused by modifying the President's plan?

Mr. CHRISTIAN. I have read your bill, Senator Roth, and I am very intrigued with it. And I think that that is something that the committee ought to consider. The particularly advantageous part of your bill, from my point of view, is that a very large part of the revenue comes from imports. And your bill also contains, I believe, another salutary element in terms of our overall tax system in that it allows a credit against payroll taxes. Payroll taxes are a very large element and a very large direct tax on work in this country. I think that the ingredients that are in your bill are something that I personally am very interested in.

Senator ROTH. I have argued that the BTT does have a beneficial impact on trade, and on employment, because my proposal would, of course, permit the BTT tax to be credited against the FICA tax. So, it does seem to me that it provides substantial new revenue that could be used to correct some of these other problems and at the same time promote American exports as well as even the trading field with respect to imports. But also, isn't it true that the

FICA offset means that it will encourage new employment, or at least eliminate some of the disincentives to new hires?

Mr. CHRISTIAN. At the 5-percent rate that is in your bill, Senator Roth, is both the relative and the absolute costs of labor in the United States are reduced. Over time, I think that would rebound quite clearly to employees because, over time, wages would rise to soak up that wedge. But it does reduce the cost of labor in the meantime.

Senator ROTH. I wonder if any of the other gentlemen would care to comment?

[No response.]

Senator ROTH. Thank you, Mr. Chairman. [Laughter.]

The CHAIRMAN. I want to ask a quick question on your chart, Ernie, and then I want to find out something else. Take a look at Japan and let's assume for a moment there is no other cost to business in any business but the cost of purchasing machinery. In your chart, what you are saying is that if a Japanese business spends \$100 this year on a machine, they get to deduct from their total gross profit \$20.60 the first year. Is that right?

Mr. CHRISTIAN. That is correct, Senator.

The CHAIRMAN. All right. Now, if there were no corporate profit tax, this whole cost recovery allowance process for depreciation would be irrelevant. You wouldn't have to deduct it against anything?

Mr. CHRISTIAN. Absolutely.

The CHAIRMAN. All right. Now, earlier, I tried to figure out what happens, assuming no foreign competition, as to where capital flows, and it was generally assumed it flows to the less capital-intensive industries. What happens now if we have no corporate profits tax in this country? Where then does capital flow?

Mr. CHRISTIAN. Capital would flow presumably to those uses where the economic return is the highest.

The CHAIRMAN. Would that be the same as the answer to my previous question? Are they going to flow to those industries that require less capital investment to get money out?

Mr. CHRISTIAN. I think it is the case that in the capital intensive industries, the rate of return on invested capital is generally less than it is in some other endeavors, and capital would very likely be harder to obtain in those industries where the profit ratio is lesser.

The CHAIRMAN. Now, let me ask the professors. Is my premise right?

Dr. AUERBACH. It is certainly true that if you lower the cost of capital, as you would not be doing for equipment investment because—

The CHAIRMAN. I just said let's get rid of the corporate profits tax. Would capital then flow?

Dr. AUERBACH. If you did away with the corporate profits tax, you would raise the cost of capital for equipment currently qualifying for the investment tax credit because—

The CHAIRMAN. What is the point of the investment tax credit if you have nothing against which you—

Dr. AUERBACH. Absolutely.

The CHAIRMAN. We don't need any depreciation or anything else, other than for whatever internal accounting purposes the company may use.

Dr. AUERBACH. The point is that to offer the combination of the corporate tax and the various investment incentives given to equipment, the investor ought to take the tax with the incentives rather than forego the tax because equipment investment currently receives, as this table shows very nicely, so much in the form of investment incentives that it more than offsets the tax that is due on those investments.

The CHAIRMAN. But you are missing the point I am asking. All I want to know for the moment is where does capital flow if there is no corporate profits tax?

Dr. AUERBACH. Are we assuming that we are starting with the present system and we get rid of the corporate profits tax? Then, capital would flow away from those sectors currently heavily using the investment tax credit.

The CHAIRMAN. Do the other two of you agree?

Dr. PRAKKEN. Yes, I agree with that. Our estimates show that, as you lower the corporate profits rate, you get a benefit because the income that you generate with capital is taxed at a lower rate, but there are two offsets. One is you lose the value of the tax deductions for depreciation, and you also lose the value of the tax deductions for interest. And our results suggest that you actually raise the cost of capital for equipment by lowering the corporate profits tax rate.

The CHAIRMAN. Dr. Fullerton.

Dr. FULLERTON. Capital would not flow between the corporate and the noncorporate sector. The corporate tax on the whole does not provide any additional tax on marginal investment. It is completely offset on the whole by this investment tax credit from the accelerated allowances. There would be some shift from equipment to structures and not between the corporate and noncorporate sector.

The CHAIRMAN. At the moment, we have a difference in types of businesses that support the President's plan versus those who don't. Those who basically support it are not heavy capital-intensive industries. Those that don't like it are heavy capital-intensive industries. Earlier, I asked if we had no foreign competition, where does the capital flow, and you basically said it flows to the less capital-intensive industries. Now, again, I am still assuming no foreign competition, and I am assuming no corporate profits tax. It still flows to the same place. And it seems to me that we are in a kind of a catch-22 situation. What the heavy industries in this country have to have is two things. One thing is they have to have a high corporate profits tax against which they can offset rather large depreciation allowances because, given a tax-neutral system, they cannot compete for capital. Is my conclusion right?

Dr. AUERBACH. I am sure Mr. Christian can tell you better than I, but I think they would be perfectly happy to have ACRS and the investment tax credit with a lower corporate tax rate.

The CHAIRMAN. Oh, to have it and lower it?

Dr. AUERBACH. Yes. I don't think it is catch-22 if you don't worry about—

The CHAIRMAN. No, I am talking about getting rid of it. What good do the breaks do them if you get rid of the corporate profits tax? I understand that to the extent we would keep it, they would like to have the highest ACRS's and ITC's possible to offset against whatever corporate rate. If there is none, what do they do?

Dr. AUERBACH. I guess they just have to compete.

The CHAIRMAN. No. Is that right?

Dr. PRAKKEN. It doesn't do them any good and they have lost an advantage that they previously had.

The CHAIRMAN. Yes. Mr. Christian? What happens in that situation?

Mr. CHRISTIAN. Mr. Chairman, I will repeat what I said before. I think that there would be an outflow of capital from those firms where the profit ratio to required capital investment is lower.

The CHAIRMAN. Then the kind of clients you represent are not in a position to move toward any kind of tax system which would perhaps substitute a business tax or a value added tax for the corporate profits tax, or the advantage that you have in deducting the cost of equipment is going to disappear. How can you possibly compete for capital in this country if we have a business transfer tax or value added tax when you no longer can have an advantage for investing in heavy capital equipment, assuming we adopt whatever the tax is that would raise the \$60 billion you now get from the corporate profits tax. How can you help but come up with losers under that?

Mr. CHRISTIAN. I don't believe that is true, Mr. Chairman. I think that what is happening here—and you have said that you are dealing hypothetically—is I believe that under the administration's proposal there is a very large corporate tax increase. That corporate tax increase is being concentrated heavily on capital equipment.

The CHAIRMAN. No, I am not talking hypothetically. I am not obligated to support the administration's position, and I am trying to look—as Senator Bradley is with his system, and Senator Roth with his business transfer tax—at what may be the best system we should moving toward. And it sounds to me like heavy industry in this country cannot afford to move toward a no-corporate profits tax or they won't attract any capital.

Mr. CHRISTIAN. I don't believe that is the case, Mr. Chairman.

The CHAIRMAN. Why isn't it? I thought we just agreed a moment ago that if there were no corporate profits tax, money would flow toward lower capital-intensive industries.

Mr. CHRISTIAN. I think you are dealing with something that is very fundamental; a tax, such as the corporate tax, does influence behavior. It does influence choices. There is no question about that. The higher the rate of tax is, the greater the influence. If we had a corporate tax rate of any rate and no deductibility of anything—you couldn't deduct capital equipment, you couldn't deduct wages, you couldn't deduct contributions to retirement plans, or anything else—then, except for the income effect of reducing the after-tax receipt from some endeavor, the tax system wouldn't have any influence on behavior, on choices of investment, savings, what to invest in, structures, equipment, whatever. We don't have that kind of a system. We have a system with—

The CHAIRMAN. Ernie, I am not interested in what kind of a system we have. I am trying to get an answer to my question as to what we might devise.

Mr. CHRISTIAN. OK.

The CHAIRMAN. And quit coming back to this is what we have.

Mr. CHRISTIAN. All right. If we had no corporate tax rate, and there was no corporate tax—

The CHAIRMAN. Yes. No corporate profits tax. No corporate income tax.

Mr. CHRISTIAN. Then, the tax system would not have any influence on whether you spend your money this way or whether you spend your money that way.

The CHAIRMAN. Yes, and given that, where would you spend it?

Mr. CHRISTIAN. You would spend it where you would get the highest rate of return.

The CHAIRMAN. Would that be in a low capital-intensive as opposed to a high capital-intensive industry?

Mr. CHRISTIAN. It could very well be.

The CHAIRMAN. Gentlemen, is that a correct conclusion?

Dr. FULLERTON. Without the corporate profits tax, capital would undoubtedly flow away from the older capital intensive businesses in the Northeast and probably toward the some of the less capital-intensive businesses—perhaps high tech, startup firms, whatever. In any case, removing a corporate profits tax would do a lot toward leveling the playing field just by itself. The corporate tax currently does a lot to unlevel the playing field by providing special breaks to particular kinds of assets over others.

The CHAIRMAN. Dr. Auerbach, the same conclusion?

Dr. AUERBACH. The removal of the corporate profits tax would, for most investments aside from the equipment investment qualifying for the investment tax credit—probably increase the incentive to invest. For the kinds of investments that we have been talking about here, that heavily utilize investment tax credits—it would discourage investment relative to the current system.

The CHAIRMAN. Do you agree?

Dr. PRAKKE. Yes, I do.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. I have followed this line of questioning under that theory, previous to the Internal Revenue in 1913, there wouldn't have been a railroad built in the country. That was capital investment. There wouldn't have been a steel mill built. That was heavy capital investment. All we would have in this country would be retail stores and hamburger stands, but that isn't the way it worked out. Now, maybe we have to get back to what Ernie Christian said—you would go where the return is. Now, maybe there isn't return in heavy capital investment. Nobody built a power plant in the country. I don't think that necessarily follows. People want power, so the rate of return on power plants and power investments—equity investments—would increase, wouldn't it?

Dr. AUERBACH. Senator, you go where the highest after tax return is, I hope.

Senator CHAFEE. I am saying with no taxes.

Dr. AUERBACH. With no taxes, that would also be the before tax return.

The CHAIRMAN. How did we ever build railroads or steel mills in this country prior to an income tax, if the incentive should have been to invest—

Senator BRADLEY. But there is a market for the service.

Senator CHAFEE. There was a market for the product, and there is going to be a market for steel.

Dr. AUERBACH. Absolutely, but what the tax system has done, as it has increased incentives for some kinds of activities, is decrease incentives for others. Obviously you are not going to wipe out an industry if there is a strong demand for the product, and it is not going to cause an industry to expand if nobody wants to buy what it is producing, but given market forces, it will cause a tilt one way or the other depending on what the incentives are. The stronger the tax incentives, the stronger the tilt.

Senator CHAFEE. But getting back to the chairman's question. It seems to me that if you conclude, as Dr. Fullerton did, that there will be a decreased investment in the northeast in some of our existing heavy capital intensive industries, because of our Tax Code and repeal of the ITC, that the decline of those industries would be accelerated because of imports.

Dr. AUERBACH. I know we are talking about taxes and so we are worrying a lot about them, but one shouldn't lose sight of the fact, as has been emphasized, that there are so many other factors that influence the profitability of companies, and not just whether there is a demand for their products, but what the exchange rate is and what interest rates are. Real interest rate movements in the last 4 years have been substantially bigger in effect than the tax change from the pre-ACRS system to the ACRS system and certainly than the change that is being envisioned here. And similarly the effect of the appreciation of the dollar that occurred in the early 1980's on competition with foreign producers just has to be a substantially more important factor than any of these tax changes that are being considered.

Senator CHAFEE. Suppose the President's proposal were adopted in toto? Would that affect any of the other items that you say affect production investment other than taxes? Would it affect the dollar?

Dr. AUERBACH. I think unfortunately—

Senator CHAFEE. Would it affect interest rates?

Dr. AUERBACH. I think, unfortunately, it would affect them because it is a revenue loser. It is a stated revenue loser in the long run. Once you decide that, to be fair, you are going to get rid of the investment tax credit and State and local tax deductibility, gradually rather than in the first year, you are not talking about anything that is close to revenue neutral. There may not be complete agreement, but I think certainly the level of interest rates today and the dollar-yen or dollar-other exchange rates today owe their levels in part to what has happened to the deficit in the last few years. And that is not going to get better under this proposal.

Senator CHAFEE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Mr. Chairman, if I could just follow up on Senator Chafee's comments and the panels answers, I think that they made some very interesting points here. They pointed out that, according to their analysis, Treasury II is a revenue loser over time. Is that correct, Dr. Auerbach?

Dr. AUERBACH. Well, that is what it says in the Treasury document.

Senator BRADLEY. OK. That is what it says in the Treasury document, which means that that revenue loss would adversely affect these other factors of production. Right? Interest rates, value of the dollar—is that correct?

Dr. AUERBACH. That is my view, yes.

Senator BRADLEY. Now, let me ask you this. If you had at least a revenue neutral—truly revenue neutral—system so that you didn't increase the deficit over time, what would be the effect of this kind of tax reform proposal on interest rates and these other factors?

Dr. AUERBACH. I think one would expect over time the effect on before-tax interest rates to reduce them somewhat because of the lower tax rates that are being paid by individuals who invest in bonds.

Senator BRADLEY. So, if you had a revenue neutral tax reform, it would have a positive impact on these other elements like interest rates, value of the dollar, and so on. I think this is a very important point because we are hearing that the President's proposal would have a negative effect, but that doesn't mean that we have to write the President's proposal. If we wrote one that was revenue neutral, it would have a positive impact on interest rates and these other factors which, as the panel has pointed out time and time again, are more important than what we have done on the tax side.

Dr. PRAKKEN. Could I follow up on that?

Senator BRADLEY. Sure.

Dr. PRAKKEN. And maybe disagree and maybe throw you out something that you want. My estimates are also that interest rates would fall following implementation of the President's reforms. However, our estimates also suggest that the reason interest rates would fall is because initially the cost of capital would rise and investment activity would be slowed. So, the overall economic environment for several years would be somewhat less favorable than without reforms. And the way you are getting those lower interest rates is through beating down the economy somewhat. Further on out, those lower interest rates can help. They will offset the initial increases and cost of capital and help spur investment back up, but initially, you won't be so much better off, even though you have lower rates.

Senator BRADLEY. I would like to ask Dr. Auerbach: You say that the President's bill will increase the deficit over time. You say that there is still considerable generosity in the proposed depreciation allowance.

Dr. AUERBACH. Right.

Senator BRADLEY. How do you weigh the tradeoff between a little less generous depreciation and a revenue neutral bill on the one hand versus very generous depreciation and a bill that increases the deficit on the other?

Dr. AUERBACH. I think the way you weigh it is if you were to trade off by simply keeping the rest of the bill the same, and increasing depreciation deductions and adding to the deficit, those assets which would gain favor by that action would probably, on balance, gain. That is, they gain more from the enhanced provisions than they would lose from the overall increase in the cost of funds. But all other assets—all other tax investments, all other uses of money—which wouldn't be receiving those specific provisions, would be hurt. So, you would be tilting your policy more toward some investments and away from others.

Senator BRADLEY. I want to change the subject if I can because I want to do this frequently as we go through these debates. I found an article in the Wall Street Journal very interesting a couple of days ago. I don't know if you saw it. The headline says: "Washington Lobbyists Enjoy Added Prosperity as Special Interests Gear Up for Tax Overhaul." It is a very interesting story, and I see under the list of Washington's top tax lobbying firms Patton, Boggs & Blow, and I see that Mr. Christian's name is listed as one of the principal members. And I want to just confirm for the record if the Wall Street Journal is right. Do you still represent Chrysler Corp.?

Mr. CHRISTIAN. Senator Bradley, our law firm is registered for and does represent Chrysler Corp. I would point out that—

Senator BRADLEY. OK. Let's just go down the list because my time is about up. Do you still represent the Retail Tax Committee?

Mr. CHRISTIAN. Yes, the law firm does.

Senator BRADLEY. Do you still represent Squibb Corp.?

Mr. CHRISTIAN. Yes.

Senator BRADLEY. Do you still represent E.F. Hutton group?

Mr. CHRISTIAN. Yes.

Senator BRADLEY. Do you want to add any others?

Mr. CHRISTIAN. But I am not representing them today, Senator. I was invited by the committee to appear, and I am not appearing on behalf of those or any other clients.

Senator BRADLEY. But you do work for Patton, Boggs & Blow?

Mr. CHRISTIAN. I am a partner in Patton, Boggs & Blow. I don't work for Patton, Boggs & Blow. [Laughter.]

Senator BRADLEY. Which means that is as close as a lawyer gets to owning it.

The CHAIRMAN. He works with Patton, Boggs & Blow.

Senator CHAFEE. He is Patton, Boggs & Blow. [Laughter.]

Mr. CHRISTIAN. Could I say one thing?

The CHAIRMAN. Yes.

Mr. CHRISTIAN. On this, I am very intrigued about the point you have been raising about the zero corporate tax and what would happen with respect to capital flows. I think that one needs to be careful there. It is not necessarily the case that the capital intensive firms in a zero tax world would lose investment. I think the point is—if you will pardon me, Mr. Chairman—that we have to look at it in terms of having a tax system. We do have a tax system now with very high rates. If a firm couldn't reasonably rapidly deduct the cost of your capital equipment, its after-tax rate of return would be very low. It is the after-tax rate of return that attracts capital.

The CHAIRMAN. I understand.

Mr. CHRISTIAN. If another firm that is labor intensive could not deduct its labor, its after-tax rate of return might go down very much also. So, it is by no means clear—to me at least—that if we did simply change tomorrow to a system in which we had a zero corporate tax rate and when we compare what is an after-tax rate of return now and what is supposed to be the no-tax return then—that capital intensive firms would lose capital. What I merely said was that repealing the ITC and ACRS, as is proposed, is going to have a particularly adverse effect under the present system. That is not necessarily the result with a no-tax system.

The CHAIRMAN. I understand that. I thought Senator Chafee's question was very good about prior to the tax system in 1913—the income tax, corporate and otherwise. Apparently, Mr. Hill, Mr. Harriman, Mr. Rockefeller, and Mr. Carnegie thought that money could be made in what were very capital-intensive industries. In fact, they didn't do badly. And at the same time, Mr. J.C. Penney was around, and Sears and Roebuck was around and Montgomery Ward, but it would seem to me that capital sought its own level. And if you had to invest more because of a capital-intensive industry, you had to charge more for your product to get what would be regarded as a sufficient rate of return to justify you to invest.

Mr. CHRISTIAN. I think that if we had a zero corporate tax, you would see a boom in this country.

Dr. FULLERTON. Mr. Chairman, I don't think there is really very much evidence to suggest that corporations do react to these incentives and depreciation allowances or investment tax credits. You can see from Mr. Christian's chart that the United Kingdom has almost immediate expensing of machinery. They have decided it was a mistake, and they are now phasing that out.

The CHAIRMAN. Oh, they are? I didn't know that.

Dr. FULLERTON. Yes. Japan has very slow depreciation allowances and no investment tax credit. There just is not any evidence, either in the history of the United States, back to times when there were no investment tax credits, as you point out, or in an international comparison to other countries where there is no investment tax credit that those kind of incentives really are of much importance in the overall investment picture.

Senator CHAFEE. Mr. Chairman, may I ask one question?

The CHAIRMAN. Yes.

Senator CHAFEE. Following through on the chairman's proposition that if there were no corporate tax, then capital would flow to where the greatest return would be. Now, let's just say that there is one uniform corporate tax that has no investment tax credits, nothing that benefits heavy industry versus retail industries, and the accelerated recovery scheme was more like the proposed one. Now, under that, some industries would have a more difficult time than they are having now. The heavy capital-intensive industries would suffer and thus, just as if there were no tax, they would have to do something to make themselves more attractive for investment. But would the result be that they would be less competitive with international competition?

Dr. FULLERTON. Senator, with a uniform corporate tax——

Senator CHAFEE. A uniform corporate tax that didn't benefit Goodrich over Montgomery Ward.

Dr. FULLERTON. But that uniform corporate tax again, just as with no tax, the available resources would go to the location with the highest productivity.

Senator CHAFEE. Highest return—I don't think productivity. A better return.

Dr. FULLERTON. That is right. It would go to where that asset would produce the highest amount and earn the highest return. Now, having a uniform tax might affect total capital formation over time, but a uniform tax for a given amount of capital at any point in time would be used in its most efficient, most productive uses.

Senator CHAFEE. But would one of the results of that be that the heavy industries who benefit from this would suffer competitively—

Dr. FULLERTON. In the short run.

Senator CHAFEE. In the short run. I mean, the steel industry might go completely.

Dr. FULLERTON. First of all, as I pointed out earlier, these firms do not react—I don't think there is any evidence to suggest that they react much to these incentives anyway. So, it won't be such a major impact as all that anyway. It might affect a little bit of investment here or there at the margin. In the second place, indeed, those equipment intensive industries probably would lose with a switch to a uniform corporate tax system, such as the one envisioned by the President's proposal, but it is because they have taken use of the incentives available under current law.

Senator BRADLEY. You mean because they have been heavily subsidized for a long period of time and because this proposal says that maybe it is time to take the cold shower. And the question is: Do you believe that taking a cold shower would eliminate the manufacturing sector in this country? That is really it.

Senator CHAFEE. In other words, would we be doing tremendous harm to the country—

Dr. FULLERTON. The short answer is no. That is not a problem, but of course, to the degree there is a problem, it could be amended by some—

Senator BRADLEY. If you believe that it is not a problem could you tell the committee why? Dr. Auerbach?

The CHAIRMAN. I want to know this—when you said the short answer is no, do you mean in the short run the answer is no or your short answer is no?

Dr. FULLERTON. If you wanted only one word, no, I am less worried about the cold shower, but the longer answer is that it would be a cold shower and you might want to soften some of that blow. I think, in fact, the CCRS does that because—relative to the Treasury proposal—it reaccelerates allowances for equipment relative to the Treasury proposal. Otherwise, you could consider some transitory phase-in provisions to warm up the water a little bit. But that, of course, might be revenue losing.

Senator CHAFEE. What would Mr. Christian say to that?

Mr. CHRISTIAN. Two things, Senator Chafee, in your questions. The administration's proposal would increase substantially the tax on capital equipment in the United States. It would be very dangerous and would be in my view a disaster to the economy and to

the GNP growth. Now, to get back to your uniform tax, and Senator Packwood's question about a zero tax rate, I would point out that if you have expensing—which is what I would like to have—expensing of capital equipment, that is the equivalent essentially of Senator Packwood's zero tax situation. Now, that is neutrality. I would very much like to have expensing or, on the other hand, the equivalent which is the zero rate. People have been calling for that for years. That would be salutary for capital equipment.

The CHAIRMAN. I beg to differ with you. That is not the same thing. If you had expensing of equipment, that is a sensational incentive toward high capital industries. That is not the same as no corporate tax.

Dr. AUERBACH. Senator, if I could try to clarify the difference? If you had expensing and you removed all deductibility of interest or forced a firm to take additional borrowing into income, then there would be no tax burden on new investors. The reason why we see expensing as such a bonanza is because it is never discussed in conjunction with the other things that would go with it to give it what has been called consumption tax treatment.

The CHAIRMAN. In essence, what you have got if you have no corporate profits tax is expensing.

Dr. AUERBACH. Expensing without a deduction for interest.

The CHAIRMAN. Yes.

Senator CHAFEE. Mr. Chairman, could I just get Mr. Christian to follow on because, frankly, the subject isn't expensing or no expensing. In the best of all worlds, maybe expensing would be there, but I don't think we are going to see it. What I want to follow on is what Dr. Fullerton said that this thing—if we just had a uniform tax as far as the benefits applied the same across the board for Montgomery Ward and United States Steel, without the ITC, without special ACRS, you said that would be devastating. Why would it be devastating?

Mr. CHRISTIAN. Senator, if you are talking about letting a steel company expense its outlay of costs in the same way you allow Montgomery Ward to expense its labor costs and its inventory costs, then that would be healthy. But what is being talked about in the administration proposal is to, on the one hand, let one firm expense its costs and, on the other hand, require a steel company to take its deductions only over a period—a very long period in the future. This isn't a uniform tax. It is a very unneutral tax that the administration is proposing.

Senator BRADLEY. Could I just follow up on that? In the first panel the head of Bethlehem Steel said that he thought the program was good and he supported it. You know, it is devastating because people might have to pay some taxes. The answer isn't bigger more subsidies, it is less. And we need to figure out how to get people to be competitive.

The CHAIRMAN. It almost seems like the whole system we have been used has ended up making certain types of industries addictive.

Senator BRADLEY. Right.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. My question is more general, and it is premised on the fact that I think a lot of problems that you folks

bring to us today and explain and hence respond to the various tax bills are caused partly by the fact that Congress changes the tax law too much. And for those that have to worry about long-term investment, they never really know what the tax law is and never really are able to make good, sound business decisions. So, my question to you is: Let's assume that we do pass exactly what the President proposes—whether you like it or not—and we do that in the next 8 months, and it is the law. How long of a moratorium on any tax changes would you think would be good for your country, your clients, your point of view so that we have got a settled situation where this country can move forward with its ingenuity, its business aggressiveness to exploit the dynamics of our economy so that we can be successful and competitive once again in the world market?

Dr. AUERBACH. Senator, I think that you may be able to change the tax structure once and for all, but eventually you are going to have to raise the rates because the deficit is probably not going to come down enough unless expenditure cuts that don't appear in the cards right now occur over the next several years. So, it is probably important to distinguish between any changes at all and changes in the basic structure. I think it probably does make some logical sense now to talk about a once and for all change in structure and then, if revenue needs are such that rate increases are needed then those could be contemplated. To make a major change as is being discussed here, with the hope that it would be a once and for all change, realistic phase-in provisions for different major changes really ought to be considered. But the alternative, it seems to me, is that immediate changes of such a large magnitude might be perceived as so unfair and so difficult in the short run as to preclude that action. I think that would be unfortunate.

Dr. PRAKKE. I see one area here that is of particular concern, and that has to do with the recapture tax, which in my judgment, is an attempt to apply tax backwards. And I think if that was implemented as part of this proposal, it would signal a significant change in the rules about the way taxes are treated from this point on. In particular, when it comes to depreciation allowances, the aspect of the capital cost recovery system which makes it look attractive is the indexing provision. The indexing provision, however, in the out years will be a very serious revenue drain for the Treasury, and it will be tempting at that point to want to take it away. And if you have already set the precedent for retroactive taxation with the recapture tax, I think the stage will have been set for an active debate on taking away the revenue loser somewhere down the road. And if I were a business person, and our clients are telling us they are very concerned about that. So, you need to have some promises that the benefits of this proposal which are going to accrue to businesses in the out years are not going to be taken back, because that is what you are using to buy their support of some of the other proposals in the short run.

Dr. FULLERTON. I don't happen to view the recapture as an additional backward looking tax. I think it is designed and works pretty well in such a way that it collects the tax that was promised on those assets when they were put in place in the first place. If I were to choose yes or no forever on the Treasury plan, I would

agree with Dr. Auerbach that it actually—I don't know if you would agree with this, but I think it works pretty well—but I agree with you that there are problems in changing the Tax Code so it would be nice, once the change were made, not to tinker with it any more although I think there is the problem of the deficit.

Mr. CHRISTIAN. Senator, I agree with you completely. It is my view that the constant state of turmoil that the tax system has been in for 10 years, including this round, does have a serious disruptive economic cost, and I think it is a matter of great concern. This bill is not going to be the final tax by any means. It will begin to be changed immediately. One can even ask the question: Why do it? Or at least why to the drastic extent that is being proposed?

Senator BRADLEY. Mr. Chairman, could I ask just one more question? I know we want to move on.

The CHAIRMAN. Yes, go ahead.

Senator BRADLEY. Does the panel see any evidence that if we changed ACRS and ITC this would be the death knell of the manufacturing industry in this country?

Dr. FULLERTON. No.

Senator BRADLEY. No? Dr. Auerbach.

Dr. AUERBACH. I think you have made it pretty difficult to answer yes to that question. [Laughter.]

But under those circumstances—

Senator BRADLEY. I mean, the fear of the committee is—or at least the fear of some members of the committee—is that you can't reduce ACRS because, if you do, my goodness, you are going to have no manufacturing industry.

Dr. AUERBACH. It is probably worth pointing out that investment incentives and effective tax rates on new investment now are very close to an historical low, since World War II. So, it is hard to believe that it would have that effect.

Dr. PRAKKEN. My view is that those industries are plagued even with the favorable treatment they have right now but I think you ought to look at it this way. The reform would undo a specific subsidy that has benefited a specific group and is going to replace it with a system that will be beneficial to large numbers of people who right now haven't even identified themselves as beneficiaries. And what you are going to do is tilt the mix of the industrial structure back in a way that is difficult to perceive right now but will probably be less capital intensive. The longrun effects of this will probably be better, but in the near term, you are going to very adversely affect particular industries that have benefited to this point, and you will have to worry about the transition.

Mr. CHRISTIAN. I think there is no question that the administration proposal is going to substantially increase the cost of capital equipment. With that substantially increased cost, there is going to be less of it. And it is certainly going to give a strong push—I don't know about your death knell—but a strong push to a lot of industries that are struggling already. If I might just say a few more words, Senator, it almost seems to me—and there was a lot of evidence of this in the Treasury's first booklet—that they looked around and saw a lot of basic industries in this country that were struggling and were not expanding as rapidly as might be desired or producing jobs as rapidly as might be desired, and the response

of the Treasury—and now the administration—to that difficulty is to tax the devil out of them. That is, to me, a little bit illogical.

Senator BRADLEY. The answer to that question was, I think, like many of the answers in the panel today, 3 to 1.

The CHAIRMAN. Gentlemen, thank you very much. We will move onto a panel of Dr. Charles Walker, Mr. Robert Mercer, Mr. Edward O'Brien, and Mr. Herbert Cohn. Dr. Walker, would you begin?

STATEMENT OF DR. CHARLES E. WALKER, CHAIRMAN, AMERICAN COUNCIL FOR CAPITAL FORMATION, WASHINGTON, DC

Dr. WALKER. Thank you, Mr. Chairman. In my oral testimony, I would like to make several points.

First, the goal of rate reduction in the administration's tax plan is most commendable. In fact, I would personally like to see rates reduced even further, at least to the 30-percent across-the-board level in the Bradley-Gephardt plan or even to the 25 percent you have suggested.

Second, to fund those rate reductions by a 23-percent increase in taxes on business corporations at a time when the economy is faltering is highly questionable economic policy. GNP growth is sluggish, industrial production is down, manufacturing employment has dropped, leading economic indicators are weak. More and more economists are predicting recession for 1986 or sooner. At such times in the past, Congress has considered business tax reductions, not increases.

Third, the chance of pushing the economy into recession and rising unemployment through tax policy is significantly increased by the proposed repeal on January 1, 1986, of the investment tax credit. The two past suspensions of the credit in 1966 and 1969 were followed by overall economic weakening and early reinstatement of the credit. The case for repeal today is even weaker than in the earlier periods. Then the economy was overheating. Today it is weakening.

Fourth, supporters assert that user costs of capital will decline under the administration plan. Presumably business fixed investment will not suffer. The burden of proof is on them, for the fact is that according to Treasury's own figures, the cash-flow relating to capital intensive business activities will be cut by a whopping \$262 billion over the next 5 years. Such huge drains suggest that business investment programs for expansion and modernization either will have to be cut back or the funds will have to be borrowed in credit markets already burdened by heavy deficit financing on the part of the Federal Government. That added business borrowing would put upward pressure on interest rates.

Fifth, the key to restoring healthy productivity growth in this country lies not in business investment in structures and inventories but in productive machinery and equipment. According to Dr. Joel Prakken, the capital cost of investment in machinery and equipment will rise by over 10 percent under the administration's plan. Treasury estimates that the effective corporate tax rate on equity financed investment and machinery and equipment will rise by 21 percentage points, assuming a 5-percent inflation rate. This rise in capital costs for productive machinery and equipment will

make it all the more difficult for U.S. industry to restore and maintain competitiveness in increasingly tough world markets for manufactured goods.

Sixth, the competitive implications of the Treasury's plan are underscored by its negative impact on capital cost recovery for machinery and equipment in this country relative to our major competitors abroad. With repeal of the ITC and cutbacks in accelerated depreciation, our reasonably competitive capital cost recovery system for productive machinery and equipment will fall to eighth place or next to last among nine industrial nations. This will increase the pressure on U.S. industry to build new manufacturing facilities abroad, particularly in Canada, further eroding our industrial base and leading to exportation of jobs. And I might insert here that, to me, this is the real significance of the chart presented earlier today by Ernie Christian. I have a similar chart in my testimony. The chart is not to compare Japan with the United States, but to illustrate the possibility of U.S. industry going abroad, particularly to Canada, South Korea, France, and elsewhere.

Finally, Mr. Chairman, I would suggest that given obvious revenue restraints, major attention in revising the administration capital cost recovery proposal be aimed at approximating expensing or immediate writeoff for investment in productive machinery and equipment. More and more economists agree that expensing of capital assets, far from being an unwarranted tax break for business, is essential if all types of businesses are to be granted fair and level playing fields in the competition for resources. Such expensing would provide adequate incentives for business to make the investment that is so crucial to productivity, competitiveness, and rising living standards for the American people. Thank you very much.

The CHAIRMAN. Thank you very much, Charlie. Mr. Mercer.

[The prepared written statement of Dr. Walker follows:]

Statement of Dr. Charles E. Walker,
Chairman, American Council for Capital Formation
before the
Senate Finance Committee

Thursday, June 20, 1985

Mr. Chairman, my name is Charles E. Walker. I am voluntary chairman of the American Council for Capital Formation. The Council is a broad based coalition of individuals, corporations, and associations from all sectors of the American economy--the investment community, basic industries and emerging ones, and Fortune 500 companies and smaller businesses. We are brought together in our support of government policies to encourage the productive capital formation needed to sustain economic growth, create jobs for an expanding American work force, and enhance the competitiveness of U.S. industries in international markets.

Mr. Chairman, I am grateful for the opportunity to appear as an invited witness and discuss the capital formation aspects of tax reform. I am speaking as Chairman of the American Council for Capital Formation but in fairness should note that some of our supporters may take exception to portions of my remarks. Public dissatisfaction with the Federal income tax has increased markedly in recent years, and, as a result, the Administration and Congress are embarked on an effort to make the Federal income tax system fairer, simpler, and more conducive to economic growth. Now that the Administration's proposal has been submitted to Congress, the American Council is most desirous of working with your distinguished Committee to make certain that capital formation, which is the key to rising living standards

for all Americans in the years ahead, is appropriately served in any final tax reform legislation.

In that respect, Mr. Chairman, the Committee has its work cut out for it. The goals of the Administration tax reform proposal are not to be quarreled with. Simplicity, fairness, lower marginal rates for individuals and business--these are objectives behind which all Americans should unite. In addition, the Administration plan is pro-capital formation in several important ways. But there are some important provisions which would set back the commendable progress toward productive capital formation encouraged by Congressional action. If those setbacks can be eliminated, good tax reform legislation can be transformed from promise to reality.

As background for my comments, let me turn first to some commonly agreed-upon criteria for a good tax system and then measure the Administration plan against those criteria.

What Makes a Good Tax System?

A good tax system possesses both horizontal and vertical equity, is simple and easy to understand, raises sufficient revenue to support an appropriate level of government outlays, helps promote the nation's social and economic goals, and utilizes taxes that are visible instead of hidden. How does the Administration tax reform proposal stack up to these criteria?

Fairness. Horizontal and vertical equity refer to fairness among income earners at the same level and also among those at different levels. Such equity is highly important but by no means the sole measure of what makes a good tax system. Since fairness is very much in the eye of the beholder, there are no objective criteria for measuring it. In a democracy, it is approached through the political process and may in some degree be a will-of-the-wisp. Nevertheless, fairness is an important goal which surely will be in the forefront of the Committee's deliberations.

As to the Administration's plan and fairness, it would level somewhat the rates paid by people in the same income group, but not by all that much. Its vertical equity has been attacked both in this Committee and elsewhere by those who believe middle-class taxpayers will be discriminated against.

Simplicity. The Administration's plan would provide some greater degree of simplicity in individual taxpaying but not very much. This greater simplicity would result primarily from increases in the zero bracket amount or the standard deduction and, therefore, simplifying taxpaying somewhat by reducing the number of itemizers. Business taxpaying will not be simplified but will, in fact, be more complex.

Revenues. There is real question whether the Administration plan will raise sufficient revenue to support an appropriate fiscal position. I am not referring here solely to the policy

decision to make the plan revenue-neutral (in static revenue terms), although I question that decision. In my own personal view, deficit reduction is so important that I believe both Congress and the Administration should be driving toward a combined spending cut and tax increase that would balance the Federal budget within the next five years.

Deficit reduction is not, however, on the agenda for this discussion; the question is, therefore, whether the Administration proposal is indeed revenue-neutral. On paper and in static terms, it is. In practical, political terms and with realistic rather than static revenue estimates, it is not--and in my judgment, it is going to be exceedingly difficult for the Committee to make it revenue-neutral unless new sources of tax revenues are found.

How far short of revenue neutrality is the Administration plan where practical politics are concerned? My guess is upwards of \$50 billion over the next five years. For example, the Chairman and others have questioned whether the depreciation recapture tax is fair; that's \$57 billion in revenue (over the five years, 1986-90), which may well be cut back. Members have also expressed support of the "binding contract" rule for depreciation and the investment tax credit; that has been estimated to cost \$8 billion, which incidentally sounds like a low estimate to me. Repeal of state and local tax deductions,

which would raise large amounts of revenue, may have to be scaled back.

It might prove to be impossible to restore balance to the bill by offsetting these and other retrenchments with sufficient new income tax revenue from so-called loophole-closing. The Committee would then have to decide whether it wanted to vote for a significant tax cut in the face of huge Federal deficits, or seek other sources of revenue. Neither choice is an easy one.

Open versus Hidden Taxes. An important goal of tax reform that has not yet emerged in the current debate involves open and easily identifiable tax burdens versus those that are hidden. Most tax reformers prefer the former. But the fact is that the Administration's plan, which is billed as involving a net tax cut on individuals, is nothing of the sort. As President Reagan, himself, has said many times, corporations do not pay taxes, people do. The corporate tax is ultimately passed on to consumers, workers, and stockholders.

The trouble is that no one knows to what degree the tax is passed on to each group. To be sure, the Administration proposes higher taxes on many regulated public utilities; these will be passed on to consumers through higher rates and are, therefore, highly regressive. On the other hand, absent an increase in protectionism, the higher taxes on steel companies cannot be passed on to consumers because of foreign competition; the higher taxes must, therefore, be borne by the company owners and

employees. These two cases are the extreme and easy to identify. Others are not.

Since, in large part, the individuals who are ultimately hit by higher corporate taxes cannot be identified, the tax is in effect a hidden tax and any increase in it is a hidden tax increase. The real truth about the Administration tax plan is that, so long as the plan is revenue-neutral, it can involve no net tax cut for people. These lower individual tax rates are offset by higher, hidden taxes on the corporations' owners, workers, or customers.

Greater reliance on hidden taxes does not seem to me to be consistent with fundamental tax reform.

Social and Economic Goals. The November Treasury plan, by sharply raising taxes on fringe benefits plus some other changes, would have worked against some important social goals relating to health, housing, and retirement. Some provisions still work in that direction. The damage is probably not all that great, however, and Congress can be expected to examine these provisions with exceeding care.

It is with respect to economic goals that the Administration plan is most questionable. Specifically, the plan seems to me to be stacked against the productive capital formation that is the mainspring of productivity growth in our economy and is, therefore, the base for lasting economic growth and rising living

standards. The remainder of my statement will be devoted to this issue.

The Administration's Tax Reform Plan and Capital Formation

Capital formation requires two actions, saving plus investment. Saving without investment is, in effect, hoarding and can lead to recession. Investment without saving requires money creation and usually causes inflation. Saving and/or investment can be carried out by individuals, corporations, or governments. Furthermore, when viewed from the standpoint of society as a whole, the saver need not be the investor. Individual saving may indirectly "finance" business investment. Moreover, saving in one sector may be offset by dissaving elsewhere. For example, the substantial dissaving represented by huge Federal deficits has been offset (or indirectly "financed") by saving in the individual and business sectors, and especially by state and local governments and foreign investors.

From a public policy standpoint, not all capital formation is equally effective in promoting rising productivity. Savings that go into the construction of gambling casinos would be viewed by most citizens as less productive--and probably less desirable--than savings which supported investment in the productive machinery and equipment that leads to efficiency and, therefore, more international competitiveness.

For these and other reasons, the Administration's tax reform plan must be judged, first, as to what it does to promote saving

by individuals, businesses, and governments and, second, what it does to promote truly productive capital formation.

The Administration's Tax Reform Plan and Saving

The Administration's plan appears to be positive in its net impact on individual saving. Reductions in high marginal rates, partial dividend deductibility, expansion of IRAs, and reduction in tax rates on capital gains might, together, offset the negative impact of taxing the "inside buildup" of insurance policies and cutbacks in salary reduction plans. Econometric analyses may throw more light on this matter.

Loss of the deductibility of state and local taxes may make it more difficult for those governmental units to run surpluses in their budgets (as they have done recently) and thus put a damper on saving in this sector. Business saving might be reduced somewhat by the provision for deductibility of 10 percent of dividends paid, but the desirability of cutting back on double taxation of corporate dividends far outweighs the drawback of lower corporate saving.

A critical aspect of the President's proposal as it affects saving--and a substantial improvement on the November Treasury plan--is the tax treatment of capital gains. The Administration proposes reducing the maximum capital gains tax rate for individuals from the current top rate of 20 percent to 17.5 percent and retaining the current law tax rate on net capital gains of corporations at 28 percent.

There are three points that need to be made on the specifics of the Administration's proposal. First, capital gains tax treatment is not restricted to a narrowly defined segment of the economy. It appropriately should be broad based because our cost of capital is much higher than that of our international competitors. Second, ironically, the impact of the Administration's proposed elimination of the deductibility of state and local income taxes is such that some investors could feel no effective capital gains tax cut or, in fact, perhaps a tax hike. Third, tax equity calls for the same proportional decreases in the corporate capital gains tax rate as is being proposed for individuals.

In his speech to the Nation on May 28, President Reagan spoke of the need to continue to encourage the risk capital investment that has gushed forth as a result of the 1978 capital gains tax reduction which originated in this Committee. He said:

Since the capital gains tax rates were cut in 1978 and 1981, capital raised for new ventures has increased over 100-fold. That old, tired economy wheezing from neglect in the 1970s has been swept aside by a young, powerful locomotive of progress carrying a trainload of new jobs, higher incomes, and opportunities for more and more Americans of average means.

There is no question in my mind that recent experience has demonstrated clearly how sensitive capital formation is to changes in capital gains tax rates.

In the early 1970s, Congress doubled the maximum tax rate on capital gains from 25 percent to 49 percent. The impact on the supply of risk capital was devastating. For example, the venture capital needed to start and finance the growth of young companies all but dried up and caused many companies to stop growing, to go deeply into debt, or in the case of technology companies, to sell or license their inventions to foreign competitors.

Fortunately, in 1978, several farsighted members of this Committee, including former Senator Clifford Hansen, Chairman Bob Packwood, and Senators Russell Long and Lloyd Bentsen, and others, recognized that if this situation persisted, our technological leadership and industrial competitiveness would be threatened. As a result of this Committee's leadership, Congress cut the capital gains tax rate from 49 percent to 28 percent for individuals and from 30 percent to 28 percent for corporations.

The results were dramatic. Within 18 months, more than \$1 billion of new venture capital flowed into funds for investment in new and growing companies. In 1983, aided by a further cut in the capital gains tax rate for individuals to 20 percent, \$4.1 billion of new venture capital was made available for investment. Compare this to the \$50 million average annual additions to the venture capital pool during 1971-77 when the tax rate was much higher.

In addition, history shows that cutting the tax on capital gains can swell Uncle Sam's coffers. In 1969, when tax rates on capital gains were raised, tax receipts from that source went down. But, when the capital gains tax rates were lowered in 1978 and 1981, tax receipts from capital gains went up, both times. In 1979, the first year of the 1978 capital gains tax cut, Treasury collected \$11.7 billion in capital gains tax revenues, up from \$8.1 billion collected in 1977 and \$9.3 billion collected in 1978. The latest estimate of capital gains tax revenues shows the trend has not slackened off; \$12.9 billion was collected in 1982.

Among the dramatic benefits to our economy of these cuts in capital gains tax rates is the availability of risk capital for start-up, high-tech, Silicon Valley enterprises. Industry experts cite favorable capital gains taxation as a critical factor in the creation of 800,000 jobs in the electronics industry over the past six years.

The capital gains provisions of the President's plan are under attack by some who say this is an unfair giveaway to the rich. The facts, however, show that it is our economy that benefits the most from the reductions in terms of new job creation, increased competitiveness, and even increased Federal revenues.

Indeed, a strong case can be made that the recent cuts in capital gains tax rates have been the most successful tax cuts in

history--both for capital formation and the government's revenues.

Productive Capital Formation

It is with respect to its impact on productive capital formation by U.S. businesses that the Administration's plan is most disturbing. Even though the Administration is to be commended for proposing a 33 percent top corporate tax rate, business capital formation will take a heavy hit if the plan is enacted. To be sure, defenders of the proposal talk about "present values" being as good or better than "expensing." The defenders ignore the critical point that when the present value of the investment tax credit is added to that of the depreciation allowance for machinery and equipment, the Administration's plan is far less generous than current law in most cases. These rather esoteric matters aside, the real story is told by the dollar amounts of tax increases that the Administration plan would levy on capital-intensive business activity.

That figure comes to a whopping \$262 billion for the first five years of the plan. As is shown in Table I, that \$262 billion dollar hit consists of \$223 billion from corporations and \$39 billion from unincorporated businesses. It results almost wholly from cutbacks in accelerated depreciation, repeal of the investment tax credit, and enactment of the depreciation recapture proposal.

The first point to emphasize is that a \$262 billion gross reduction in cash flow at capital-intensive companies, even though offset in part by a lower tax rate, is bound to have a negative impact on business investment in plant and equipment in the five-year period under consideration. Whether things would improve after 1990 is an interesting but not really relevant question; so much investment ground will be lost in the next five years that later catch-up will be very difficult. It should also be noted that the theory that "greater neutrality" in taxing the returns on all business capital assets will lead to higher productive capital formation through greater efficiency is just that--a theory. The current system is not a theory. It has been put in place over several decades and, with the fine boost it received in 1978 and 1981 tax legislation, has contributed to an excellent record of productive capital formation in recent years.

The Special Case of Productive Machinery and Equipment

The most damaging aspect of the Administration's tax reform plan to productive capital formation is undoubtedly the significant increase in tax rates on investment in productive machinery and equipment. The Administration states that the effective corporate income tax rate on such investment would rise from -4 percent (assuming 5 percent inflation) to +17 percent, an increase of 21 percentage points. Another way to look at the impact of less favorable tax treatment of productive machinery and equipment is to consider the length of the period it takes to recover the capital used to buy the assets. Based on data on the

capital cost recovery system in nine industrial nations compiled by Arthur Andersen & Co., the U.S., under present law, now ranks third with respect to capital costs recovered within 5 years and fifth for costs recovered within 3 years. But as is shown in Chart I, abolition of the ITC and cutbacks in accelerated depreciation as proposed by the Administration would drop the U.S. to eighth with respect to both 3- and 5-year cost recovery.

The significance of this large increase in the tax impact on investment in productive machinery and equipment is difficult to overstate. Investment in modern, state-of-the-art business equipment makes productivity rise. A business can produce efficiently in a building that is five, ten, or even twenty years old--provided that within that structure it has modern, efficient machinery and equipment. In short, growth in productive machinery and equipment as opposed to structures or inventories, which are relatively favored by the Treasury plan--is the key to jobs, economic growth, and international competitiveness.*

The international aspect of unfavorable tax treatment of investment in productive machinery and equipment is especially important. The U.S. is a high-wage economy. By and large, we compete with many countries whose wages are much lower than ours.

*The Administration's plan would cut corporate tax rates on equity financed investment in structures and inventories by 14 to 15 percentage points. It would raise the corporate tax on investment in productive machinery and equipment by 21 percentage points (the rate computations assume a 5 percent inflation rate).

To hold our own in that environment, we must either bring our wages down or offset them with more efficiency in production--and that requires investment in state-of-the-art machinery and equipment.

The huge stakes involved in the Committee's decisions as to taxing investment in productive machinery and equipment are emphasized by the worsening position of American basic industry. This is manifested by a "lopsided" economic recovery and a "two-tier" economy, in which services are booming but basic industry is falling back. The major problem here, of course, is the impact of the Federal deficit in keeping interest rates higher here than abroad, the foreign capital that those high rates help attract, and the resulting overvaluation of the U.S. dollar. That overvalued dollar makes it difficult for U.S. firms to export and easier for U.S. importers to buy abroad. As the trade deficit has zoomed upward to an annual rate of \$140 billion, basic industries have seen their markets erode. Industrial production is, therefore, down, as is employment in manufacturing. More and more companies are considering whether they should build new manufacturing facilities abroad, partly because of the high dollar and already favorable tax treatment of new investment in most industrial countries. Passage of the Administration's plan as drafted could not help but further undermine this nation's industrial base by speeding up that outflow of U.S. manufacturing capacity and jobs.

The Canadian situation vis-a-vis the U.S. provides a good example. Suppose that the Administration's tax plan passes and that a U.S. automobile company in Michigan decides to replace an outmoded production facility. Does it build in the U.S., where it would receive no investment credit and the productive machinery and equipment would, in large part, be written off over seven years? Or would the company build the new facility only a few miles north, in Canada, where it would receive an up-front investment tax credit of 7 percent and write-off its total investment in three years? The attractiveness of this deal would be enhanced greatly by the fact that the cars produced more economically in the Canadian plant would be exported to the U.S., where profits on marketing and distribution would be taxed (under the new law) at only 33 percent.

Supporters of the Administration's proposed increase in taxes on investment in productive machinery and equipment argue that many other factors affect the cost of capital and many other factors affect business decisions to locate here or abroad. That is true, but tax considerations are significant in each case. For this Committee to decide in favor of the Administration's plan, and significantly raise taxes on business investment in productive machinery and equipment, it would also have to conclude--it seems to me--that we either do not have a problem of international competitiveness, along with threatened export of manufacturing capacity and jobs,¹ or that there is no relationship

between capital costs of machinery and equipment and the decisions as to where to locate new facilities.

The Committee will, I am sure, gather adequate testimony on that matter and consider it carefully. If as a result you decide to improve the tax treatment of productive machinery and equipment, there are several ways to do so.

Improving Tax Treatment of Productive Machinery and Equipment

Judging by my discussions with economists of all persuasions, the most intellectually acceptable method of improving the tax treatment of investment in productive machinery and equipment without undermining neutrality in business taxation would be to permit expensing of all capital assets, i.e., to allow immediate write-off at time of purchases or installation, just as is the case with other business expenses now. The economic literature abounds with support for this approach. It is the method that is implicit in pure consumption taxes, which exempt all saving and investment--individual and corporate--from taxation.

The objection to expensing all capital assets is, of course, that it would be too big a revenue drain in the early years. If the Committee determines that revenue drain to be unacceptable, then the better part of wisdom would, therefore, seem to be to concentrate on attaining expensing of investment in machinery and equipment, which is so crucial to productivity growth and international competitiveness, as contrasted with investment in

structures and inventories. This is just the opposite of what the Administration has proposed. Perhaps Administration officials overlooked the negative impact on productivity and competitiveness of a tax shift in favor of structures and inventories and against productive machinery and equipment. Perhaps the Administration would be willing to consider some alternative approaches.

Retention of the ITC would be the best and most direct method of assuring appropriate tax treatment of productive machinery and equipment. However, on a static revenue basis, this would pull some \$165 billion from the tax plan over the next five years. It would destroy any semblance of revenue neutrality and balloon the Federal deficit. It could not be considered unless other sources of revenue were tapped.

If the Committee wants to shift taxation of productive machinery and equipment back toward, but not fully to, expensing--even though this would risk curtailing productivity growth and enhancement of our international competitiveness--some half-measures are possible. One would be to shift revenue dollars from structures and inventory taxation to equipment. This could be accomplished through adjustment in the proposed depreciation schedule or retention of some, if not all, the investment tax credit. Moreover, it is the Committee's task to weigh the various components of the Administration's package--revenue gainers and losers--against the clear advantage to

productivity and competitiveness of retaining the investment tax credit.

An Industrial Policy?

Some proponents of strict tax neutrality between capital-intensive and noncapital-intensive businesses argue that to provide for defacto expensing of investment in productive machinery and equipment, while continuing to tax investment in structures and inventories at positive rates, would in effect constitute an "industrial policy," or repudiation of a free market approach. They maintain that resource allocation through market forces will provide the best recourse allocation for efficiency and growth over time.

In general, the market is a much better allocator of economic resources than is the government. But the fact is that few foreign governments place as much faith in the market approach as we do. They clearly see the advantage of drawing resources into investment of productive machinery and equipment and are not at all bashful at shaping their tax systems for that purpose. For the U.S. to insist on following economic theories that disadvantage this country in international trade--and at precisely the time when international competition is hammering away at basic U.S. industry--is to put doctrine ahead of competitive reality. U.S. companies are already competing with one hand behind their backs due to the strong dollar, closed markets in other countries, targeted trade practices, and unfair

subsidies to output in those nations. The Administration's plan, if enacted, would make the competitive position of the U.S. manufacturing industry even worse. I hope this Committee, which has demonstrated sensitivity to trade concerns, will not acquiesce to the proposed increased in taxes on productive machinery and equipment.

One other point relating to taxes and industrial policy should be noted. The media have largely bought the argument that tax-based investment incentives (including integral aspects of business capital cost recovery, such as accelerated depreciation and the ITC) represent favoritism to capital-intensive activities and are "unfair" to noncapital-intensive businesses. This interpretation ignores the fact the capital sunk in expensive business investments for expansion and modernization in basic industries often takes many years to recover. Until those capital costs are recovered, net earnings are much less than gross earnings. If those companies could immediately write off their purchases of plant, equipment, and inventories, as is the case with most expenses in noncapital-intensive activities, they could enjoy real net profits at the outset. The "playing field" would be much more neutral and fair to capital-intensive and noncapital-intensive alike.

Indeed, there is considerable merit to the argument that a tax system which prohibits businesses from expensing capital assets (either directly, or indirectly through use of accelerated

depreciation and the ITC) is in itself an industrial policy, but a wrongheaded one that works against U.S. competitiveness in world markets.

Business Tax Increases in a Faltering Economy

The Administration tax reform plan would sharply increase taxes on business corporations (by \$19 billion, or 23 percent, in 1986 alone) at a time when the U.S. economy is already showing signs of weakness. Growth in gross national product has been anemic. Industrial production and manufacturing employment are down. Leading economic indicators are weak. Not a few economists are predicting recession for 1986. Whether one is Keynesian, supply-side, or whatever, an increase in taxes on business activity is hardly the macroeconomic prescription when business activity is weakening. In the past, such times have been occasions for business tax cuts, not increases.

Repeal of the investment tax credit, along with other cutbacks on capital cost recovery, are especially questionable today. Nurtured by the capital recovery tax cuts in 1981, business investment led the recovery from the recession of that year and helped sustain it into 1985. Recently, however, business capital spending has been levelling off. New orders for nondefense durable equipment declined by 7 percent last month.

For the year 1985, business spending on new plant and equipment is expected to be less than half of the 1984 amount.

These trends suggest that repeal of the ITC in 1985 might well risk a repeat of the 1966 and 1969 experiences. In those instances, Congress acceded to requests by Presidents Lyndon Johnson and Richard Nixon to suspend or repeal the ITC only to have to reverse these actions when the economy faltered. Surely Congress does not want to take action today which will have to be reversed in only a short time.

Conclusion

Mr. Chairman, President Reagan has presented a blueprint for tax reform that provides a starting point for your distinguished Committee. If passed in its present form, the Administration's plan would run the serious risk of tilting the economy toward recession and higher unemployment by sharply increasing taxes on business activity. In addition, the proposed increase in taxes on investment in productive machinery and equipment would strike at the greater efficiency which is the key to international competitiveness, job creation, and expanding living standards for all Americans.

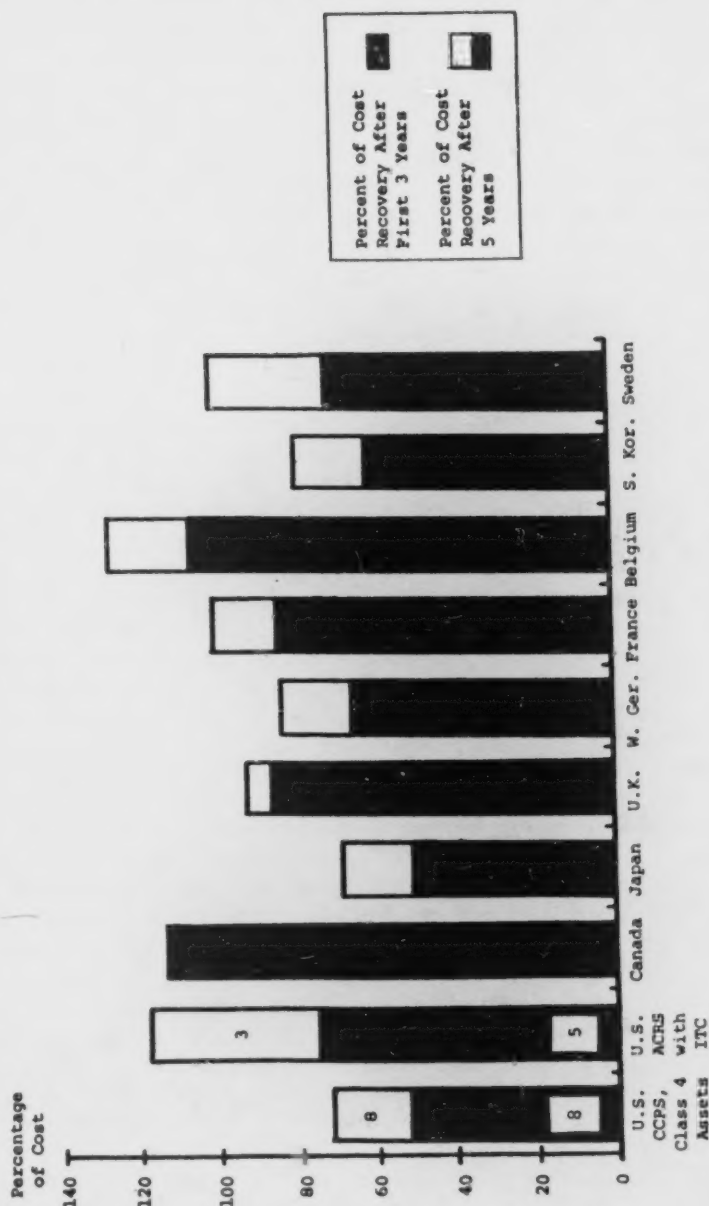
The American Council for Capital Formation stands ready to work with your Committee, Mr. Chairman, as you re-shape the Administration proposal so that it will effectively serve all the goals of fundamental tax reform.

Table 1: The Revenue Impact of Change in the Current Law Capital Cost Recovery System

	Fiscal Years				Total
	1986	1987	1988	1989	
Adjust depreciation schedule and index for inflation					
Individual	0.1	0.3	1.3	3.6	11.1
Corporate	0.3	-0.7	2.3	8.7	26.0
Repeal Investment Tax Credit					
Individual	1.7	4.8	5.6	6.4	25.7
Corporate	14.0	25.6	29.4	33.3	139.7
Recapture of Rate Differential on Accelerated Depreciation					
Individual	*	0.3	0.3	0.5	1.1
Corporate	7.6	19.4	20.4	9.1	56.5
Allow expensing of first \$5,000 of depreciable business property, repeal scheduled increases					
Individual	-	-	0.1	0.3	0.7
Corporate	-	-	0.2	0.3	0.9
Total					
Individual	1.8	5.4	7.3	10.8	38.6
Corporate	21.9	44.3	52.3	51.4	223.1
Total Individual & Corporate	23.7	49.7	59.6	62.2	261.7

Source: The President's Tax Proposal to the Congress for Fairness, Growth and Simplicity, May 1985, p. 455.

Chart 1: Ranking for Cumulative Cost Recovery Allowances for Machinery and Equipment in Leading Industrialized Countries for the First Five Years



Source: Arthur Andersen & Co.

STATEMENT OF ROBERT E. MERCER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, GOODYEAR TIRE & RUBBER CO., AKRON, OH; AND MEMBER, COALITION FOR JOBS, GROWTH AND INTERNATIONAL COMPETITIVENESS

Mr. MERCER. Yes, good morning, Mr. Chairman, and members of the Senate Finance Committee. I am Bob Mercer, chairman and chief executive officer of the Goodyear Tire & Rubber Co. and one of three cochairmen of the Coalition for Jobs, Growth, and International Competitiveness. The coalition is dedicated to the preservation and strengthening of this Nation's industrial base for we believe that a nation cannot live on services alone. Industrial productivity remains the indispensable engine for creation of jobs and growth. The maintenance of strong capital formation incentives in a tax system is a crucial element in the effort to promote job creation, economic growth, and international competitiveness. Attached to my prepared statement is a listing of the coalition's 18-member corporations. We represent important manufacturing sectors of the American economy, and we are highly capital-intensive and operate in a global market. Now, while the coalition supports President Reagan's tax reform goals, we cannot support Treasury II as it is currently proposed. We hope that our remarks today will be helpful in creating a better package to meet these goals for, in our view, the Treasury II plan would result in a severe drain of the short-term cash-flow of capital-intensive industries, particularly those who invested most in response to the Economic Recovery Act of 1981. Using my company, Goodyear, as an example, the administration's proposal would decrease our cash-flow over the next 5 years by nearly \$270 million. This is money that otherwise would be available for purchasing productive machinery and equipment. The plan not only limits our economic growth but also has the unacceptable effect of limiting our ability to compete internationally at a time when imports are flooding this country. Now, our concern can be traced to several provisions. Most disturbing is the provision to impose a windfall tax on past investment. This represents a discriminatory retroactive tax on incentives intended to stimulate investment. The provision would result in a drain on cash that is currently budgeted for reinvestment. One coalition member, that is AT&T, has stated that this depreciation provision would increase its expenses about \$1 billion over the next 3 years. Goodyear's increase over the same period would be \$57 million. Now, that is money that has to come out of current cash-flow. We believe this provision cannot be justified and should be eliminated. The repeal of the investment tax credit is a program we have been through twice before, and each time it has had a strangling effect on the economy. If you look at the chart on my left, you will see that it shows what happened in both cases. In 1962, when President Kennedy put the tax credit in, investments and jobs increased. When President Johnson removed the tax credit in 1966, the growth rate in spending and jobs took a nosedive. Now, the same was true when President Nixon repealed the investment tax credit in 1969, after it had been reinstated by President Johnson 2 years earlier. Each upward line reflects the installation of the investment tax credit, and each downward line shows the repeal of that tax credit.

Given the state of today's economy, we believe that it would be bad for this country to have the investment tax credit repealed again. We feel that by extending depreciation over a 7-year period, the proposed depreciation system makes capital projects less viable, and we urge you to retain the current law. The lowering of the tax rate from 46 percent to 33 percent is supposed to compensate for losing the present incentives for investments, but lowering the tax rate doesn't create investment. The investment tax credit and the accelerated depreciation rate are incentives to make production machinery and equipment, and it is this type of investment that creates the jobs and provides the income for people in a tax base for this country. For without these investment incentives, we drive the country toward a service-related economy where the investment is minimal. Under the present tax law, Goodyear recently invested \$250 million in a plant in Tyler, TX, to make it globally competitive in the radial tire industry. If Treasury II had been in effect, that plant would have been located in Canada or perhaps offshore. The Tyler project occurs just 5 years after a \$216 million investment at our tire plant in Lawton, OK. So, here we have the most modern tire plant in the world that is no longer state of the art because of newer technology. And at the same time, Goodyear has invested \$840 million in an oil pipeline to bring offshore California crude to Texas refineries. This investment could not be justified under Treasury II.

The country would be the loser in both of the examples that I have just mentioned. We hope to have additional opportunities with you, the administration, and the House Ways and Means Committee to structure a program that will provide jobs, enhance our international competitiveness, and stimulate growth in this Nation's economy, but thank you for giving me the opportunity today.

The CHAIRMAN. Thank you, Mr. Mercer. Mr. O'Brien.

[The prepared written statement of Mr. Mercer follows:]

STATEMENT OF R E MERCER
CO-CHAIRMAN, THE COALITION FOR JOBS, GROWTH,
AND INTERNATIONAL COMPETITIVENESS
BEFORE THE FINANCE COMMITTEE
U.S. SENATE

June 20, 1985

I am Bob Mercer, Chairman and Chief Executive Officer of The Goodyear Tire & Rubber Company and Co-Chairman of The Coalition for Jobs, Growth, and International Competitiveness.

The Coalition for Jobs, Growth and International Competitiveness is a recently formed coalition of, at present, 17 major corporations from a broad cross-section of American business. You can see from the list of companies that while we are all fairly different in make-up, we have several important things in common: we represent important manufacturing sectors of the American economy; we are highly capital-intensive; and, most of us are exposed to an increasingly competitive world trade picture. In sum, we represent a fairly typical snapshot of American manufacturing in the mid 1980's, with all the mounting pressures--and opportunities--you have heard so much about these days.

This coalition started forming a few months ago, after Treasury I first appeared, because while we support the basic concept of tax reform, we feel strongly that it must not be done in a manner which harms the manufacturing base of our economy. Our concern is that the tax reform proposal under consideration achieves reduced tax rates at the expense of capital investment in the U.S. Any tax reform package which does that will have a negative impact on jobs, economic growth, and the ability of the U.S. manufacturing base to compete internationally.

Let me briefly comment on how this reform proposal works against capital investment in the U.S.

Repeal of the Investment Tax Credit or ITC. Loss of the ITC will substantially increase the cost of productive machinery and equipment for American business. This, in turn, will have an extremely negative effect on new productive machinery and equipment and will undermine the competitive position of American companies in world trade. Twice in our past history Congress has repealed the ITC and each time has reinstated it shortly thereafter, because of the negative impact repeal had on productive machinery and equipment and jobs in the U.S. This chart shows the decline in the level of productive machinery and equipment and jobs each time Congress has repealed the ITC and the subsequent increase when it was reinstated.

The Capital Cost Recovery System (CCRS). The comparison of the proposed CCRS to the existing Accelerated Cost Recovery System ACRS, is simple. CCRS expands the number of classifications for assets from 5 under ACRS to 6 and in all classes except 3 year ACRS property lengthens the time over which the capital investment is recovered. In an era where we are experiencing rapid technology advancements as applied to the manufacturing process it does not seem appropriate to lengthen the recovery period and put the investment at risk for an even longer period of time. I'll give you a specific example of how rapidly the manufacturing technology has changed for Goodyear shortly.

Depreciation "Penalty Tax". Treasury II includes a highly undesirable proposal to recapture 40% of the so-called "excess" depreciation taken in prior years. This proposal is just downright unfair: it amounts to changing the rules of the game in mid-stream. When depreciation recapture and extended depreciation recovery periods are added to the loss of the ITC, the increased tax on business far outweighs the benefit of the corporate rate reduction.

Congress' original intention in coupling ACRS with the ITC was to enable manufacturers like ourselves to recover the cost of purchasing new machinery and equipment as quickly as possible. Certainly, in the current climate that original intention is more important than ever. In his testimony before this committee the Secretary of the Treasury, the Honorable James A Baker III, stated that "Investment incentives are maintained through a system of depreciation allowances that is accelerated relative to economic depreciation". Under the Reform Proposal the repeal of investment credit, the stretching of capital cost recovery periods and the imposition of a "Penalty Tax" on prior depreciation increases the tax burden on the capital investment of corporations by \$222 billion over 5 years. Granted the proposal also includes a 13 percentage point rate reduction, but it falls far short offsetting the \$222 billion increase.

Goodyear is a capital intensive company with approximately 70,000 employees in the U.S. We have major facilities in 24 states. (refer to attached list) Goodyear, like many other capital-intensive companies, is in a net borrowing position. Obviously there are finite limits to our borrowing capacity. In the end an increase in our tax liability will reduce the amount of money which we will have available for new investment.

I think Goodyear's situation is fairly typical of the members of the coalition. Let me explain how we have dealt with foreign competition and the concern that we have about the impact the Reform Proposal would have on capital investment in the U.S. and on our ability to compete in the world marketplace.

The Tax Reform Proposal increases substantially investment costs and that impairs our ability to compete. Our major competition comes from companies in France, Japan and more recently includes Korean manufacturers. These competitors have two important advantages over us: These are (1) lower labor costs and (2) economies which are managed to encourage export to the U.S. but at the same time limit competition from U.S. imports. Goodyear has been able to offset these competitive disadvantages by continually making substantial capital investments in state-of-the-art manufacturing processes, most recently in our Oklahoma, Kansas, North Carolina, and Texas plants. By reducing our ability to recover these expenses, this proposal effectively raises the cost of our capital investments and seriously impacts our primary competitive advantage. At the same time our foreign competitors will enjoy a very favorable 33% tax rate on their earnings from imports into the U.S., thereby improving their already favorable situation.

Let me give you a specific example of how important the manufacturing technology is and how rapidly it changes. In 1979 Goodyear invested over \$200 million in a new state-of-the-art tire manufacturing process and facility in Lawton, Oklahoma. Five years later when we were making a \$250 million commitment to convert an obsolete bias tire plant in Tyler, Texas to state-of-the-art radial tire technology the machinery and equipment which we installed in Lawton five years earlier was no longer at the cutting edge and a new improved generation of equipment was used. It is that kind of capital investment in new manufacturing processes which has allowed Goodyear to retain its status as the number one tire producer in terms of technology and quality in the world. I question whether we would be there if the tax reform proposal currently under consideration was in effect five years ago.

Another of our major capital projects, the 1,768 mile oil pipeline stretching from offshore California thru Arizona and New Mexico to the Texas Gulf Coast was evaluated based on a precise analysis of cash flow. This project is critical to this country's goal of energy independence. We wouldn't have made the commitment under the proposed tax reform and, even worse, the reform proposal doesn't provide for a grandfather provision to allow us to recover our investment as planned. This is merely a retroactive tax increase under another name. The government has reneged on a commitment on which we relied in making our investment decision.

In summary, if we examine closely the economic philosophy relating to capital investment embodied in this tax reform proposal and the alternatives available to U.S. manufacturers it can be briefly summarized in the following manner. (1) Export your investment and the related jobs and manufacture your product in a foreign location such as Canada, Europe, or possibly Mexico where there are incentives for capital investment. (2) Import

-4-

the product into the U.S. where there is a relatively low tax on the income derived from the sales function. While our economy has shown significant growth since 1981, many of you have expressed concern over the significant trade imbalance which exists and its potential future impact on the economy. We should not be moving tax policy in a direction which encourages more of the same.

Thank you for the opportunity to make this brief statement today on the Administration's tax reform proposal. I look forward to pursuing this important subject with you--which goes to the very heart of American manufacturing--at greater length in the near future.

Locations of Major Goodyear Facilities

Alabama

Arizona

California

Georgia

Illinois

Iowa

Kansas

Kentucky

Ohio

Oklahoma

Maryland

Massachusetts

Michigan

Missouri

Nebraska

New York

North Carolina

Pennsylvania

Texas

Tennessee

West Virginia

Wisconsin

Vermont

Virginia

Coalition for Jobs, Growth and International
Competitiveness - Member Companies

Ameritech, Inc

Amoco Corporation

AT&T

Atlantic Richfield Company

BellSouth Corporation

The Boeing Company

Boise Cascade Corporation

Champion International Corporation

Chevron Corporation

Commonwealth Edison Company

Ford Motor Company

The Goodyear Tire & Rubber Company

Houston Natural Gas Corporation

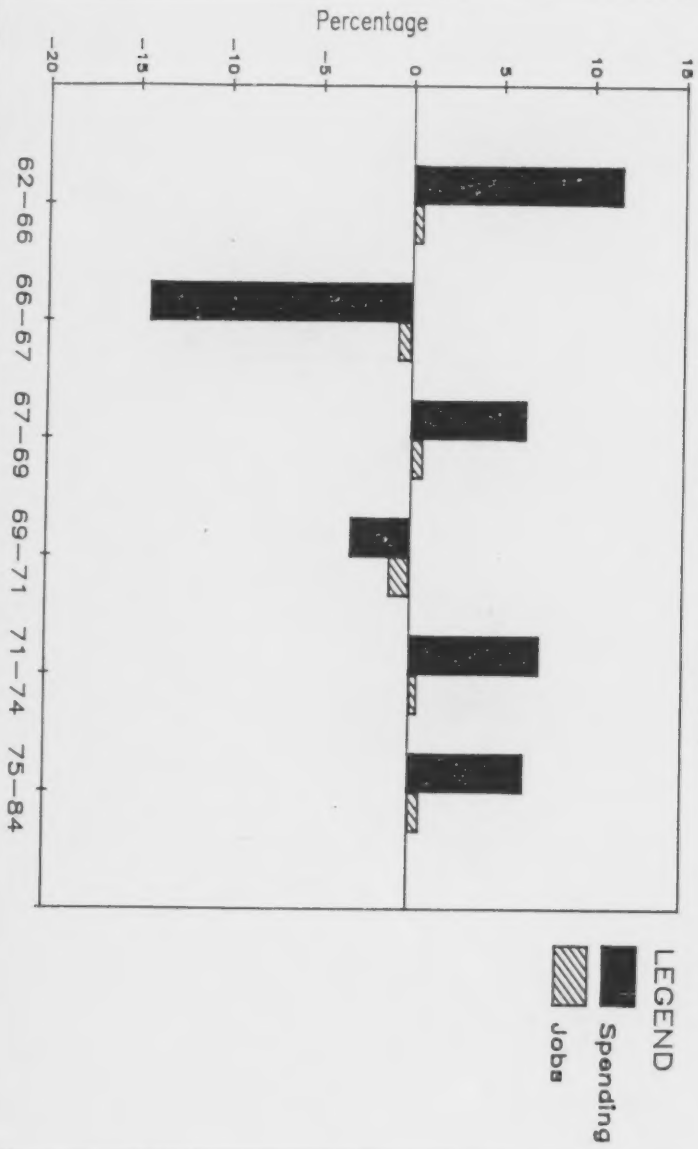
Inland Steel Company

Southern Company Services, Inc

Southwestern Bell Telephone Company

Weyerhaeuser Company

Growth Rate—Producers Durable Equipment Employment/Population Ratio 1962 — 1984



STATEMENT OF EDWARD I. O'BRIEN, PRESIDENT, SECURITIES
INDUSTRY ASSOCIATION, NEW YORK, NY

Mr. O'BRIEN. Mr. Chairman and members of the committee, good morning. I am Edward I. O'Brien, president of the Securities Industry Association, and with me today is M. Bernard Aidinoff, a partner of Sullivan & Cromwell. We very much appreciate the opportunity to appear before the committee. SIA represents the U.S. Securities Industry, whose basic job is really twofold: To raise capital for corporations, entrepreneurs, and Government, and second, to provide investment guidance to corporations, investors, and institutional money managers, as well as Government. Our industry uses a broad range of financial products in seeking the right combination of services and products to meet our clients' needs. Tax rates, whether as incentives or disincentives, play a major role in our finding the most appropriate combination. Reducing rates, broadening the tax base, and encouraging savings and investment are compatible goals of tax reform. Congress has taken steps toward all three objectives since the measures which were put into effect in 1978. Incentives for investment are indeed a special interest—special not only to 42 million investors, but to the creation of jobs and to the Nation's economy. I would like to commend the committee and the Congress for past measures reducing tax rates on capital gains, as well as for the shortened holding period. Congress took these steps despite a great deal of skepticism and some opposition to the changes. Now, 7 years after that process began in 1978, I can report that these actions were significant in the capital formation process in creating jobs and increasing tax revenues. In other words, it worked. My written statement documents in greater detail the beneficial effects of these lower capital gains taxes on revenues, initial public offerings, venture capital, and share ownership, and let me just cover them briefly. Tax receipts from capital gains grew by \$2 billion in 1979 and have continued to grow since. The capital gains exclusion provides an incentive to take risks. Despite actual experience since capital gains rates were first reduced in 1978, some individuals ignore the facts and they continue to rely on static analysis in arguing that the exclusion cost the Government tax revenues. Revenues are not the only factor affected positively by lower capital gains tax rates. Between 1979 and 1981, nearly 3 million jobs were created, most of them by small companies where the impact of lower capital gains rates was most dramatic. By last year, initial public stock offerings raised 15 times the capital that was raised in 1978. Venture capital disbursements grew 600 percent during the period. The number of Americans owning stock increased 68 percent between 1975 and 1983, to over 42 million. So, again, it seems to have worked. Today, I want to express our industry's support for further reductions in capital gains taxes as reflected in the administration's proposal. Congressional support, we believe, will be as beneficial as were the previous tax reductions on capital gains. Above all, in our judgment, lower capital gains taxes will lead to greater rather than less tax revenues. As documented in the Arthur Andersen study attached to our written statement, taxes on capital gains around the world are, by and large, lower than in the United States. Tax policy must recognize

the important part that taxes play in the very competitive worldwide financial and trading markets.

The high cost of equity capital has made corporations dangerously reliant on debt. In 1960, corporations had over \$4.00 of equity for each dollar of debt. By last year, that ratio had been cut in half. Most other industrialized nations have integrated corporate and individual taxes, but in the United States, interest on debt is fully deductible while after-tax dividends are taxed again at the shareholder level. This double taxation is mitigated only by a token dividend exclusion which has been in the Code since 1954. The President has proposed allowing corporations to deduct 10 percent of the dividends paid to shareholders. That proposal provides greater recognition of double taxation than present law, and we endorse it. I also wish to support the successful IRA and 401(k) Programs which were made possible by congressional action and raised billions of dollars for savings. I urge you to support expanding IRA's to non-working spouses and to reject proposals which would reduce savings through 401(k) plans. In conclusion, I want to restate our strong support for lower capital gains taxes. Such action in the past has led to highly beneficial results for just about everyone concerned. If you have any questions, I would be pleased to try to answer them. Thank you.

The CHAIRMAN. Thank you, sir. Mr. Cohn.

[The prepared written statement of Mr. O'Brien follows:]

STATEMENT OF THE
SECURITIES INDUSTRY ASSOCIATION
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
JUNE 20, 1985

Mr. Chairman and members of the committee, I am Edward I. O'Brien and appear here today as President of the Securities Industry Association. I appreciate the opportunity to participate in the committee's hearings on the need for tax changes to stimulate capital formation, savings and investment.

SIA represents about 520 securities firms headquartered throughout the United States and Canada. Its members include securities organizations of virtually all types--investment banks, brokers, dealers and mutual fund companies, as well as other firms functioning on the floors of the exchanges. SIA members are active in all exchange markets, in the over-the-counter market and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for approximately 90% of the securities business being done in North America. Because of their role in the capital markets, SIA members are in a position to recognize the impact of tax policy on investment decisions by corporations and investors.

Since the late 1970s, Congress has been concerned about using tax policy to achieve several important goals. Foremost among these goals has been the promotion of economic growth by reducing tax disincentives on savings and investment.

SIA believes strongly that creating tax incentives to save and invest is an essential step in promoting economic growth. We have stressed the importance of lowering taxes on investment income to encourage risk-taking. A key factor in furthering this goal was and remains the lowering of taxes on capital gains. We believe that such a step not only encourages desirable economic objectives but actually leads to greater tax revenues for the government. The experience since the tax cut on capital gains in 1978 strongly supports our conclusions.

Impact of Capital Gains
Tax Changes
1978 and 1981

The Revenue Act of 1978, through an increase in the capital gains tax exclusion from 50% to 60% and other changes, cut the maximum capital gains tax rate from 49% to 28%. Congress enacted that legislation because the high tax rate on capital gains contributed to a shortage of funds for capital formation, with the result that rates of economic growth declined and the competitive position of the U.S. deteriorated. The 1981 drop in marginal tax rates served to enhance the returns from savings and investment and reduced the maximum tax on capital gains to 20%.

Although no one factor is responsible for the decision to save or invest, the after-tax return on investment is clearly a prime consideration. There is considerable evidence to support the effectiveness and efficiency of the 1978 and 1981 tax cuts. While the following trends are subject to countless influences, the 1978 and 1981 tax cuts had a positive impact in spurring capital formation.

Initial Public Offerings

New and emerging companies have created the largest number of new jobs. Over 2.7 million jobs were created between 1979 and 1981, with 60% of the increase in total employment contributed by small businesses with fewer than 500 employees.^{1/} The increased market value placed on the stocks of smaller companies produced a market climate conducive to the initial public offerings (IPOs) of new and emerging companies. In other words, the public was willing to provide emerging companies with equity capital for expansion and investment.

The effect of the 1978 capital gains tax reduction on capital formation was consistent with the experience of the immediately preceding period. From 1969 to 1975, following increased capital gains taxes, the new issue market almost evaporated. The number of issues and the amount of dollars raised plunged 99%, from 548 issues raising \$1,457.7 million to 4 issues raising \$16.2 million. In the first half of 1978, only 16 companies went public, raising a meager \$64.2 million.

^{1/} The State of Small Business: A Report of the President,
U.S. Small Business Administration, March 1983.

When passage of the Revenue Act was imminent in the second half of 1978, 29 companies came to market, raising three times the capital obtained during the first half. From 1979 to 1984, the number of companies going public increased impressively and the amount of money raised soared.

During this period, 1983 marked an exceptional year. Boosted by initial public offerings of thrift institutions converting from mutual to stock companies, new issues numbered 888 and funds raised totaled \$12.6 billion. Despite adverse market conditions, 1984 saw an impressive 548 companies go public, raising \$3.8 billion. While this may seem pedestrian compared to 1983's outstanding performance, in the context of the past 15 years, 1984 ranked second in dollars raised and third in number of IPOs.^{2/}

Table II

Initial Public Offerings

	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983*</u>	<u>1984</u>
Number of Issues	40	46	81	237	448	222	888	548
Share Value (\$ Millions)	\$153	\$250	\$506	\$1,397	\$3,215	\$1,470	\$12,604	\$3,832

Source: Going Public

* Includes IPOs of thrift institutions.

^{2/} Going Public, Howard & Co., 1/17/85.

Venture Capital

Venture capital is important in financing the development of companies in rapidly growing industries. Following the 1969 capital gains tax increase, new funds committed to venture capital firms averaged only \$58 million in the 1970-77 period, reaching a peak of \$97 million in 1970 and a low of \$10 million in 1975. In 1978, however, venture capital firms raised a striking \$570 million. After dipping to \$319 million in 1979, venture capital committed leaped to \$900 million in 1980 and then to an estimated \$1.7 billion in 1982.

Table III

Venture Capital (In \$ Millions)

	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984E</u>
Committed	\$ 39	\$570	\$ 319	\$ 900	\$1,300	\$1,700	\$4,500	\$4,000
Disbursed	\$400	\$550	\$1,000	\$1,100	\$1,400	\$1,800	\$2,800	\$3,200

Source: Venture Capital Journal

Estimates place the amount of venture capital committed in 1983 and 1984 at over \$8 billion. Correspondingly, disbursements have climbed significantly, with an estimated \$6 billion disbursed to new business in 1983 and 1984. Venture capital experts believe that the vigorous and sustained expansion of the venture capital industry resulted primarily from government actions that: (1) reduced the capital gains tax in 1978; (2) relaxed pension trust investment rules in

1979; and (3) further reduced the maximum tax on investment income from 70% to 50% in 1981.

Shareownership

Shareownership as reported by the NYSE climbed steadily from 1952 to 1970, reaching a peak of 30.9 million individuals or 15.1% of the population. From 1969 to 1977, taxes on investment income (capital gains) were raised, and shareownership waned dramatically. From 1970 to 1975, shareownership dropped 22% to 25.3 million individuals, or 11.9% of the population. However, by mid-1980, shareownership was on an uptrend, one that continued until at least mid-1983, the latest survey period. At mid-1983, 42.4 million individuals directly owned stock or mutual funds, representing over 18% of the population. This figure excludes "indirect" shareownership; that is those individuals who participate in pension plans with huge investments in equities.

Table IV

Shareownership

<u>Survey Year</u>	<u>Shareowners (millions)</u>	<u>% Change</u>	<u>Shareowners as % of Population</u>
1965	20.1	--	--
1970	30.9	53.3	15.1
1975	25.3	(18.1)	11.9
1980	30.2	19.5	13.5
1981	32.3	6.8	14.4
1983	42.4	31.3	18.1

Source: NYSE

International Tax Treatment of Capital Gains

In 1978, the trend of taxation of investment income in the U.S. made a distinct turn. Shifting from a system that penalized savings and investment -- with capital gains rates as high as 49% and marginal tax rates of 70% on interest and dividends -- the U.S. has reduced the tax burden on savings and investment in recent years. These are positive steps in bringing the U.S. treatment of savings and investment closer to that of foreign countries. Nevertheless, an SIA-commissioned study by Arthur Andersen & Co. of the international tax treatment of capital gains shows that the U.S. tax system is harsher than that of other major industrial countries and countries in the Pacific Basin, one of the fastest growing economic areas in the entire world. (The Arthur Andersen study *available on request*)
~~is attached to our testimony~~

Of the sixteen foreign countries reviewed, nine exempt capital gains completely from taxation. In terms of the maximum tax rate applying to short-term capital gains, only two countries apply a rate higher than the U.S. Sweden uses the same rate as the U.S. Australia sets a 61% tax on short-term gain, with a one-year holding period required for tax exemption as a long-term gain. Moreover, Germany, with a 56% short-term rate, requires six months for long-term gain exemption and exempts short-term gain up to DM 1,000 (\$305+).^{3/} The remaining four countries taxing short-term gain apply rates

^{3/} Conversions in this section as of April 15, 1985.

Table V

Comparison of Individual Taxation of Capital Gains
on Portfolio Stock Investment in
Industrialized & Pacific Basin Countries

Country	Maximum Short-Term Capital Gain Tax Rate*	Maximum Long-Term Capital Gain Tax Rate*	Period to Qualify for Long-Term Gain Treatment	Maximum Annual Net Worth Tax Rate
United States	50%	20%	Six Months	None
<u>Industrialized Countries</u>				
Australia	61%	Exempt	One Year	None
Belgium	Exempt	Exempt	None	None
Canada	17%	17%	None	None
France*1	16%	16%	None	2%
Germany	56%	Exempt	Six Months	.5%
Italy	Exempt	Exempt	None	None
Japan	Exempt	Exempt	None	None
Netherlands	Exempt	Exempt	None	.8%
Sweden	50%	20%	Two Years	3%
United Kingdom*2	30%	30%	None	None
<u>Pacific Basin</u>				
Hong Kong	Exempt	Exempt	None	None
Indonesia	35%	35%	None	.5%
Malaysia	Exempt	Exempt	None	None
Singapore	Exempt	Exempt	None	None
South Korea	Exempt	Exempt	None	None
Taiwan	Exempt	Exempt	None	None

Note: Based on exchange rates on April 15, 1985. Special allowances or exemptions upon conversion to U.S. dollars may appear less generous than intended by deliberate public policy due to the strong position of the U.S. dollar since our last comparative international study in June 1983.

* State, provincial and local tax rates not included.

*1 Gains from proceeds of up to \$27,237 (PF 251,500) are exempt from taxation in a given taxable year.

*2 The first \$7,140 (L 5,600) of gain is exempt annually.

ranging from 16% to 35%, substantially below the current U.S. maximum rate.

Eleven of the sixteen foreign countries exempt long-term capital gains from taxation. Of those countries taxing long-term gain, two apply rates higher than the U.S. and Sweden uses a 20% rate. Canada and France apply rates of 17% and 16%, respectively, to short- and long-term gain. In addition, annual securities sales of under FF (\$27,237) in France are exempt from capital gain taxation.

Only three foreign countries have a holding period. Germany has a six-month holding period before gains are tax-exempt. In Australia, a one-year holding period is required for exemption. Sweden has a two-year holding period. Thus, thirteen foreign countries do not distinguish between short- and long-term gain.

Revenue Impact

Prior to the 1978 capital gains tax cut, opponents of the cut argued two main points. First, capital gains tax revenues would decline because of the lower rates and, second, any spurt in gains realized from 1978 to 1979 would be a one-time phenomenon, with gains drifting to lower levels by 1980. The following data disprove both arguments. Actual experience demonstrates the fallacy of the static revenue estimation technique, which assumes that loophole closings and lower rates will have no effect whatever on the behavior of taxpayers, the

growth of taxable income or anything else in the economy.^{4/}

To assume that individuals do not respond to tax changes defeats the very purpose of tax reform!

Revenues

Capital gains tax revenues collected in 1979 and 1980 exceeded Treasury projections for those years before passage of the 1978 Revenue Act. Moreover, taxes paid on capital gain income continued to increase in 1981 and 1982. The 1982 figure, the latest available, is notable as lower marginal tax rates, passed in the 1981 Tax Act, were in effect. Given the substantial jump in the Statistics of Income series of sales of capital assets, it is very likely that taxes paid on capital gains increased in 1983.

Realizations

Capital gains rate reductions have prompted dramatic increases in realizations. From 1978 to 1979, realizations jumped 45.3% to \$73.4 billion. By comparison, total capital gains realized increased 11.5% to \$50.5 billion in 1978 from \$45.3 billion in 1977. Total realizations have continued to rise from the 1979 plateau. The Economic Recovery Tax Act of 1981, which cut the maximum tax on investment income to 50%, further encouraged realizations. Preliminary data indicate that 1982 realizations were \$90.2 billion, representing an 11.5% increase from the 1981 figure. In addition, based on

^{4/}"Tax Reform, An Editorial Series," The Wall Street Journal, April 1985.

data from the Statistics of Income series, 1983 sales of capital assets jumped 32.3% to \$45.5 billion from the 1982 level of \$34.4 billion.

Table VI
Revenues and Realizations
(\$ Billion)

	<u>SOI Series</u>		<u>Treasury Series</u>	
	<u>Sales of Capital Assets (net gain less loss)</u>	<u>Total Gains</u>	<u>Taxes Paid on Capital Gain Income</u>	<u>Effective Tax Rates</u>
1977	\$20.8	\$45.3	\$8.1	17.88%
1978	23.2	50.5	9.3	18.50
1979	28.4	73.4	11.7	15.89
1980	29.7	74.6	12.5	16.71
1981	30.8	80.9	12.7	15.61
1982	34.4	90.2 ^P	12.9 ^P	14.31 ^P
1983	45.5 ^P	N.A.	N.A.	N.A.

Source: Statistics of Income Bulletin and Office of the Secretary of the Treasury, Office of Tax Analysis.

P=Preliminary data

Distributions of Realizations & Total Tax Liability

There are two distinct shifts in the distribution of net long-term capital gains as shown in Table VII. Until 1979, capital gains were centered in the \$30,000 to \$100,000 income class, with the largest percentage received by the \$30,000-\$50,000 AGI group. Realizations in 1979 increased dramatically and, with that increase, a shifting occurred in the distribution of gains. While all income groups reported more realizations, the relative share of the top income group

Table VII

Net Long-Term Capital Gain in Excess of
Net Short-Term Loss
(All Returns, \$ Billions)

ACI (\$000)	% of		1978		% of		1979		% of		1980		% of		1981		% of		1982		% of	
	1977	Total	1978	Total	1978	Total	1979	Total	1979	Total	1980	Total	1980	Total	1981	Total	1981	Total	1982	Total	1982	Total
0-10	\$5.8	13.2%	\$5.7	11.8%	\$6.9	9.8%	\$6.8	9.7%	\$6.8	9.7%	\$6.8	9.7%	\$6.8	9.7%	\$8.4	10.9%	\$8.4	10.9%	\$8.4	9.7%	\$8.4	9.7%
10-20	6.3	14.4	6.8	14.0	7.0	10.0	7.2	10.3	7.2	10.3	7.2	10.3	7.2	10.3	5.5	7.1	5.5	7.1	4.9	5.7	4.9	5.7
20-30	6.0	13.7	6.7	13.8	7.6	10.8	7.6	10.8	7.6	10.8	6.7	9.7	6.7	9.7	6.1	7.9	6.1	7.9	4.5	5.2	4.5	5.2
30-50	7.4	16.8	8.6	17.7	11.0	15.6	11.0	15.6	9.4	13.4	9.4	13.4	9.4	13.4	9.6	12.5	9.6	12.5	9.0	10.4	9.0	10.4
50-100	6.8	15.5	7.9	16.3	10.7	15.2	10.7	15.2	11.9	17.0	11.9	17.0	11.9	17.0	13.0	16.9	13.0	16.9	12.9	15.0	12.9	15.0
100-200	4.2	9.6	5.2	10.7	7.6	10.8	7.6	10.8	8.2	11.7	8.2	11.7	8.2	11.7	9.9	12.9	9.9	12.9	10.5	12.2	10.5	12.2
200+	7.4	16.8	7.6	15.7	19.5	27.7	19.5	27.7	19.7	28.2	19.7	28.2	19.7	28.2	24.5	31.8	24.5	31.8	36.0	41.8	36.0	41.8
Total	\$43.9	100.0%	\$48.6	100.0%	\$70.5	100.0%	\$69.9	100.0%	\$69.9	100.0%	\$69.9	100.0%	\$69.9	100.0%	\$77.1	100.0%	\$77.1	100.0%	\$86.1	100.0%	\$86.1	100.0%

Note: Figures may not add to total due to rounding.

Source: Statistics of Income

rose significantly. In 1982, the effect of the reduction of the capital gains tax rate was similar. The \$200,000-and-over income group realized almost 42% of capital gains in 1982. The volume and value of realizations in any given year are effected by many factors, including economic and market conditions as well as taxes. However, the data indicate that individuals, particularly upper income individuals, were very inclined to realize capital gains in 1979 and 1982, the first two years following a reduction in rates.

Increased realizations have translated to higher Treasury revenues. Even with the decline in the maximum capital gains tax rate in 1978 and 1981, the amount of revenues raised increased. While realizations since 1978 have been centered in the upper income group, these individuals are subject to proportionately higher tax rates. More, not less, revenue has been generated by those realizing capital gains in recent years despite reduced capital gains rates.

Table VIII shows returns and tax liability of AGI groups as a percentage of the respective totals. Although the proportion of returns filed by the over \$100,000 income groups remained relatively the same in 1981 and 1982, the share of tax liability for these classes increased in 1982 despite a lower maximum tax rate. In 1983, there was both an increase in returns filed in the \$50,000 and above income groups, from 5.6% to 6.6% of total returns, and a corresponding increase in tax liability of these groups from 35.4% in 1982 to 39.1% of the total.

Table VIII

Total Returns & Tax Liability by
AGI Group

AGI (\$000)	1980		1981		1982		1983	
	% of Total Returns	Tax	% of Total Returns	Tax	% of Total Returns	Tax	% of Total Returns	Tax
0-10	26.8%	3.6%	25.1%	3.1%	25.5%	2.9%	23.3%	2.5%
10-20	33.3	16.1	31.8	14.1	30.4	12.7	30.4	11.7
20-30	21.1	21.4	20.8	19.6	20.4	18.8	20.2	16.8
30-50	14.6	27.8	17.1	30.3	17.5	30.2	19.5	29.9
50-100	3.4	15.8	4.4	17.9	4.7	18.1	5.5	19.4
100-200	0.6	7.7	0.7	7.5	0.7	7.8	0.8	8.0
200+	0.2	7.6	0.2	7.5	0.2	9.5	0.3	11.7
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Note: Figures may not add to total due to rounding.

Source: Statistics of Income

The concentration of capital gains in the upper income strata raises the argument that reduced capital gains taxes benefit only the rich. It is true that wealthy individuals benefit from a lower rate on capital gains in the sense that, if they had realized the same amount of capital gains at ordinary income tax rates, their tax liability would be higher.^{5/} However, most capital gains would not in fact be realized at higher rates, as investors would simply hold on to their assets rather than selling them. No tax revenue is derived from unrealized "paper" gains. This "lock-in" effect has serious implications for the efficient allocation of capital and retards tax revenues.

Other Items

Deduction for Dividends Paid

Since initiation of an income tax in 1913, economic distortions have been caused by the double taxation of dividends. The taxation of both corporate income and dividend payments holds undue sway over corporate financial policy, with negative ramifications for capital accumulation, income distribution, and ultimately economic growth.

The consequence of the debt bias in the current tax code has led to a preference for debt over equity financing. The heavy reliance of American corporations on debt financing is demonstrated in the protracted deterioration of the traditional

^{5/} Bruce Bartlett, "The Federal Tax Debate: Capital Gains," Background, The Heritage Foundation, 12/27/84.

measures of balance sheet health. For example, measured in terms of equity to debt, corporations had \$4.08 of equity to every dollar of total debt in 1960.^{6/} In 1984, the ratio was \$2.13 to every dollar. A weaker balance sheet increases the vulnerability of corporations to economic downturns, as corporations strain to meet scheduled interest payments.

Congress acknowledged the built-in debt bias of the tax code in 1954 with the initiation of a dividend exclusion for individual taxpayers. The exclusion recognized the double tax burden placed on corporate income. The proposed 10% corporate-level deduction for previously taxed corporate earnings paid out as dividends is a modest, but more meaningful, easing of the burden of double taxation than exists in current law. In this case, the U.S. would be following the lead of seven other major industrial countries which have instituted various forms of integration to mitigate the problem of double taxation. Of eleven major industrialized countries, only the U.S., Australia, the Netherlands and Sweden are without integration of some kind for corporate and individual income taxes.

Naturally, the reduction of the rate of corporate tax also directly reduces the burden of double taxation. Partial dividend deductibility coupled with reductions in the maximum corporate and individual rates will enhance the relative attractiveness of equity versus debt. Policies which reduce

^{6/} The Financial Health of U.S. Corporations, New York Stock Exchange, March 1983.

the corporate preference for borrowing and encourage the use of equity financing will improve not only the financial condition of corporations but also long-term prospects for economic growth.

Increased Spousal Individual Retirement Account Limit

SIA supports the expansion of the IRA provisions to allow spouses working in the home the advantage of this tax incentive for private savings. Since liberalization in 1982, IRAs have drawn an overwhelming response from households over a wide range of income levels. As of November 1984, 28% of all households owned an IRA, with almost two-thirds having an income of less than \$40,000.^{1/}

Not only have IRAs proved popular savings vehicles for households, but they have effectively increased the savings pool. Although estimates of "new" money flowing into these savings vehicles are difficult to make, the Life Insurance Marketing and Research Association estimates that 53% of the 1982 IRA contributions and 56% of the 1983 contributions represents new savings. Sixty percent of IRA holders said they would have saved this money even without IRAs, but 29% said only a portion would have been saved and 11% would have spent all of it. Using another estimation technique, the Investment Company Institute estimates that the availability of IRAs contributed at least \$10 billion to total savings in 1983 which, in the absence of IRAs, would have been spent.

^{1/} IRAs--The People's Choice, Investment Company Institute.

IRAs have become a widely used and effective savings vehicle. Individuals benefit in that retirement funds are increased and the economy benefits in that the supply of savings has been expanded.

401(k)

Maintenance of the current \$30,000 annual maximum contribution rate is important for a number of reasons. Knowledgeable individuals estimate that approximately two and a half million workers currently participate in these plans, a large number of whom earn between \$20,000 and \$30,000 a year. With the American retirement system based on a combination of social security, private pension plans and individual savings, the proposed legislation would seriously discourage the use of the 401(k) savings vehicles by individuals at all income levels. Specifically, the offsetting of the 401(k) contribution by the amount of IRA contribution would eliminate or discourage participation in one or both of these vehicles; withdrawal and loan restrictions would inhibit participation by employees; and limiting the top contribution to \$8,000 would discourage people from maximizing their savings.

Imposition of an \$8,000 savings limit and withdrawal and loan provision restrictions would have a material impact on the long-range commitments and retirement plans made by individuals through 401(k) plans. The public perception of a short-term Congressional commitment to personal retirement savings will seriously discourage future participation in a valuable source of funds for capital formation.

Limited Partnerships and Direct Investments

We would like to address an issue not contained in the latest Treasury proposal: taxing limited partnerships with more than 35 limited partners as a corporation.

This so-called "35 partner rule," contained in the Treasury's November 1984 proposed tax reform, would have eliminated virtually all of the public and private limited partnership business being done by our member firms. The dropping of this proposal was wise for the following reasons:

- "abusive tax shelters" have been eliminated - The Tax Reform Act of 1984 effectively eliminated the "abusive" types of offerings; those that were structured to produce tax deductions equal to multiples of the dollars invested and had little economic value.
- a minority of the "tax shelter" business consists of tax shelters - In 1984, income-oriented partnerships accounted for more than half (53%) of the sales of total public partnerships and are projected to comprise a larger share this year.^{8/} A survey of our members indicates their corresponding figure for 1984 was approximately 67%.

^{8/} The Stanger Review, "Annual Limited Partnership Sales Summary," February 1985, p. 1.

- limited partnerships are net taxpayers - "Large publicly registered investment partnerships in the aggregate report net taxable income".^{9/}
- limited partnerships are critical to U.S. capital formation - In 1984, public and private partnerships raised over \$17 billion.^{10/} Of this amount, 59% involved real estate and 18% oil and gas investments.
- limited partnerships have broad public appeal - According to the Real Estate Securities and Syndications Institute, more than 1,000,000 investors bought limited partnership interests during the period 1980-1984, with an average investment of less than \$10,000.

^{9/} 1/18/85 letter from Robert A. Stanger, Chairman, Robert A. Stanger & Co. to Ronald A. Pearlman, Acting Secretary for Tax Policy, Department of the Treasury, p. 1.

^{10/} The Stanger Review, "Annual Limited Partnership Sales Summary," February 1985, pp. 2 and 6.

Municipal Bonds

Last year, Congress enacted a series of provisions designed to curb the use of tax-exempt industrial development bonds. Tax-exemption was prohibited for such abusive uses as skyboxes, casinos, airplanes, liquor stores and health clubs. In addition, issuance of industrial development bonds was limited to \$150 per capita or \$200 million. That ceiling is due to be reduced to \$100 per capita next year, when the small issue exemption is scheduled to be repealed except for manufacturing facilities, which will expire in 1987. Several proposals would further restrict the issuance of private purpose bonds. SIA believes that further curbs will raise little revenue, and should be delayed until the laws enacted last year become effective and their efficacy can be assessed. At the very least, any further restrictions should be carefully drafted to avoid precluding the use of tax-exempt financing for public purpose projects which may have insignificant or indirect benefits for private entities.

In 1969, Congress considered and rejected proposals to include municipal bond interest as a preference item subject to a minimum tax. Some current minimum tax bills resurrect this issue. SIA believes that such proposals are inappropriate, raise constitutional questions, and would significantly increase state and local government borrowing costs.

Summary

The reduction of tax disincentives on savings and investment has encouraged and supported economic progress in the 1980s. Savings and investment are the critical link to capital formation and economic growth. We must continue policies that are effective and efficient in encouraging savings and, ultimately, healthy economic growth.

STATEMENT OF HERBERT B. COHN, CHAIRMAN, COMMITTEE FOR
CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT,
WASHINGTON, DC

Mr. COHN. Thank you, Mr. Chairman. I appear here today as chairman of the Committee for Capital Formation Through Dividend Reinvestment. We urge that the dividend reinvestment provisions of the Code, which were enacted in 1981 for a 4-year trial period, should now be made permanent. These provisions provide for the deferral of current taxes on a limited amount of dividends reinvested under qualified original issue dividend reinvestment plans. I would like to refer briefly to four points in support of our position.

First, these provisions have now been in effect for three and a half years. They have proven to be a resounding success in terms of broad and enthusiastic shareholder acceptance and in achieving the objectives of increased savings, investment, and new common stock capital formation. As shown in the survey attached to my statement, some 3 million shareholders throughout the country are now reinvesting dividends under qualified original issue plans. Such reinvestment has virtually trebled in the period during which the legislation has been in effect. Qualified plans are now providing new common stock capital at an annual rate of about \$4 billion. And this \$4 billion a year of common stock capital provides the essential base for raising twice as much, or well over \$8 billion in bonds and preferred stock.

The dividend reinvestment legislation has proven to be one of the most direct, most closely targeted, and most cost-effective proposals for encouraging new external capital formation where it is urgently needed. It is most direct because the reinvestment in new issue stock represents instantaneous formation of new capital. It is most closely targeted because it represents a rifle shot which is 100 percent effective in providing new common stock capital to companies having an urgent need for such capital. This is so because it is only the highly capital-intensive companies having a continuing need for new common stock capital which have adopted dividend reinvestment plans for new issue stock.

Second, surveys show that the large majority of the participants in the qualified dividend reinvestment plans are the small stockholders—the holders of 1 to 300 shares, generally the middle-income taxpayers. It appears to be generally agreed that the Internal Revenue Code and the administration's tax proposal tend to leave the middle-income taxpayer as the forgotten man. The dividend reinvestment legislation has been a particular help to him, and he should be permitted to retain its benefits.

Third, there appears to be general agreement that it would be desirable to eliminate, or at least reduce, the double tax on corporate dividends. We submit that the most equitable and cost-effective first step in eliminating the double tax on corporate dividends is to eliminate or defer such tax at the shareholder level, where the shareholder has reinvested his dividend and does not, in fact, receive any cash but instead receives stock.

Fourth, the dividend reinvestment legislation accords with essential fairness. When a conventional stock dividend is declared at the

election of the company, no current tax is imposed. Why should not the receipt of stock rather than cash at the shareholder's election also be treated for tax purposes as the equivalent of a conventional stock dividend, not subject to any current tax?

In conclusion, the dividend reinvestment legislation has received the enthusiastic acceptance of some 3 million participating shareholders, primarily among the middle-income taxpayers, and has been a resounding success in achieving its objectives. It has received the endorsement of some 18 national associations representing industry, shareholders, labor, and regulatory agencies. These are listed in my statement. They range from the American Association of Retired Persons to the Building and Construction Trades Department of the AFL-CIO, the National Association of Regulatory Utility Commissioners, and the U.S. Chamber of Commerce. Extension of the dividend reinvestment legislation will make a substantial contribution to increased savings, capital formation, capital investment, and productivity. It will do so in a highly cost-effective way, and it should, we submit, Mr. Chairman, be made a permanent part of the Internal Revenue Code. Thank you.

The CHAIRMAN. Thank you.

[The prepared written statement of Mr. Cohn follows:]

STATEMENT OF
HERBERT B. COHN, CHAIRMAN
COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT
IN SUPPORT OF EXTENSION OF THE DIVIDEND
REINVESTMENT PROVISIONS OF SECTION 305(e)
BEFORE THE
SENATE FINANCE COMMITTEE
June 20, 1985

My name is Herbert B. Cohn. I appear here today as Chairman of the Committee for Capital Formation Through Dividend Reinvestment. The members of that Committee are listed in Appendix A of my Statement.

Section 305(e) of the Internal Revenue Code provides for the deferral of current taxes on a limited annual amount of dividends reinvested under qualified original issue dividend reinvestment plans. We urge that these provisions, which were enacted in 1981 for a 4-year trial period, should be made permanent.

Prior to the adoption of Section 305(e), a shareholder who elected to reinvest his cash dividend and to take, instead, what is essentially a stock dividend, was required to pay a current tax on the value of the stock received. This is in contrast to the tax treatment of the conventional stock dividend, declared at the election of the company, where no current tax is imposed. Under Section 305(e), the stock received on reinvestment under a qualified plan is regarded, for tax purposes, as essentially the

equivalent of a conventional stock dividend with similar tax consequences. In essence, this results in a downward adjustment of cost basis and, if the stock is later sold at a profit, in a capital gains tax.

I. The Dividend Reinvestment Legislation Has Been Demonstrated to be Highly Cost-Effective in Encouraging Savings, Investment and New Capital Formation Where Needed.

The objective of Section 305(e) was to encourage increased savings, investment and new common stock capital formation by providing an incentive for increased participation in qualified original issue dividend reinvestment plans. These provisions have now been in effect for 3 1/2 years. They have proven to be a resounding success - in terms of broad and enthusiastic shareholder acceptance and in achieving the objective of increased savings, investment and new common stock capital formation.

As shown in the Survey attached to my Statement as Appendix B, some 3 million shareholders throughout the country, are now reinvesting dividends under qualified original issue plans. Such reinvestment increased by almost 70% in 1982 (the first year for which the legislation was applicable), as compared with 1981, and has virtually tripled in the period during which the legislation has been in effect. Qualified plans are now providing new common stock capital at an annual rate of about \$4 billion. And this \$4 billion a year provides the essential base for raising about twice as much, or well over \$8 billion, in bonds and preferred stock.

The effectiveness of the incentive provided by the dividend reinvestment legislation has been further demonstrated by the

fact that the rate of growth in qualified plans has been more than five times the rate of growth in non-qualified plans.

The dividend reinvestment legislation has been proven in the 3 1/2 year trial period to be one of the most direct, most closely targeted and most cost-effective proposals for encouraging new external capital formation where it is urgently needed. It is most direct because the reinvestment in new issue stock represents instantaneous formation of new capital. It is most closely targeted because it represents a rifle-shot which is 100% effective in providing new common stock capital to companies having an urgent need for such capital. This is so because it is only the highly capital-intensive companies, having a continuing need for new common stock capital, which have adopted dividend reinvestment plans for new issue stock. And, indeed, where such companies no longer need new common stock capital, they have eliminated such plans or converted them into market plans. The reason for this is a very practical one. A company which does not need additional common stock capital will not want to sell additional shares and unnecessarily dilute the per share earnings and market price of its stock.

It is clear, therefore, that the dividend reinvestment legislation has substantially increased savings, investment and new common stock capital formation and helped significantly in providing capital where it is essentially needed. The revenue loss associated with its extension, which has been estimated, on a gross basis without taking into account feedback, at \$600 million, is about 15% of the new common stock capital being provided.

II. The Principal Beneficiary of the Tax Deferral for Reinvested Dividends Has Been the Middle-Income Taxpayer.

Surveys show that the large majority of the participants in the qualified dividend reinvestment plans are the holders of 100-300 shares - middle-income taxpayers. In general, the annual cap (\$750/1500) on the incentive provided by the dividend reinvestment legislation has not significantly influenced the larger investors who are likely to prefer the alternatives of tax exempt bonds or companies with low dividend payouts and high capital gains potential (which are, typically, not the kind of companies adopting original issue dividend reinvestment plans).

It appears to be generally agreed that the Internal Revenue Code - and the Administration's tax proposal - attempt to deal primarily with the particular circumstances and problems of the low income and high income taxpayers and tend to leave the middle-income taxpayer as the "forgotten man". The dividend reinvestment legislation has been of particular help to the middle-income taxpayer and he should be permitted to retain its benefits.

III. The Dividend Reinvestment Legislation Helps to Reduce the Double Tax on Corporate Dividends.

There appears to be general agreement that it would be desirable to eliminate or at least reduce the double tax on corporate dividends. The Administration's tax proposal includes a small step in that direction by providing for a deduction, at the corporate level, equal to 10% of dividends paid. We submit that the most equitable and cost-effective first step in eliminating the double tax on corporate dividends is to eliminate or defer such tax at the shareholder level when the shareholder opts for and receives

the equivalent of a stock dividend rather than cash.

IV. The Dividend Reinvestment Legislation Accords With Essential Fairness.

When a conventional stock dividend is declared at the election of the company, no current tax is imposed. On the other hand, where it is the shareholder's election to receive stock rather than a cash dividend, such shareholder has been required to pay the current tax on the value of the stock received. We submit that fair treatment should provide - as the dividend reinvestment provisions do - that a shareholder electing to receive the equivalent of a stock dividend rather than cash, should have the receipt of such stock treated, for tax purposes, in the same way as receipt of a conventional stock dividend.

CONCLUSION

In the 3 1/2 year trial period during which it has been in effect, the dividend reinvestment legislation has received the enthusiastic acceptance of some 3 million participating shareholders - primarily among the middle-income taxpayers and has been a resounding success in achieving its objectives. In the hearings before this Committee and before the House Ways and Means Committee, which preceded the adoption of the legislation, it received strong support from a cross section of capital-intensive companies, investment bankers, commercial bankers, economists and academicians, and was endorsed by a large number of associations representing industry, shareholders, labor and regulatory agencies including:

American Association of Retired Persons
American Bankers Association
American Council for Capital Formation

American Gas Association
American Society of Corporate Secretaries
Building and Construction Trades Department, AFL-CIO
Business Roundtable
Committee for Publicly Owned Companies
Edison Electric Institute
International Brotherhood of Electrical Workers
International Union of Electrical, Radio and
Machine Workers
International Union of Operating Engineers
Laborers' International Union of North America
National Association of Regulatory Utility
Commissioners
National Investor Relations Institute
Stockholders of America
U.S. Chamber of Commerce
U.S. Independent Telephone Association

Extension of the dividend reinvestment legislation will make a substantial contribution to increased savings, capital formation, capital investment and productivity, and will do so, in a highly cost-effective way. We submit that the dividend reinvestment legislation should be made a permanent part of the Internal Revenue Code.

COMMITTEE FOR CAPITAL FORMATION
THROUGH DIVIDEND REINVESTMENT

MEMBERS
(as of 2/11/85)

ALLEGHENY POWER COMPANY
BROOKLYN UNION GAS COMPANY
CAROLINA POWER & LIGHT COMPANY
CENTRAL AND SOUTH WEST CORPORATION
CLEVELAND ELECTRIC ILLUMINATING COMPANY
COMMONWEALTH ENERGY SYSTEM
CONNECTICUT NATURAL GAS CORP.
DAYTON POWER AND LIGHT COMPANY
EMPIRE DISTRICT ELECTRIC COMPANY
HOUSTON LIGHTING & POWER COMPANY
MANUFACTURERS HANOVER CORPORATION
MINNESOTA POWER & LIGHT COMPANY
NIAGARA MOHAWK POWER COMPANY
NORTHWESTERN PUBLIC SERVICE COMPANY
PHILADELPHIA ELECTRIC COMPANY
PUBLIC SERVICE COMPANY OF COLORADO
SAVANNAH ELECTRIC AND POWER COMPANY
SIERRA PACIFIC POWER COMPANY

February 22, 1985 APPENDIX B

RE: SURVEY OF 1983-1984 PARTICIPATION IN DIVIDEND REINVESTMENT PLANS

1. This Survey of participation in original issue dividend reinvestment plans in 1983-1984 covers 25 qualified and 3 non-qualified plans. The totals for qualified plans appear in Table I and for non-qualified plans in Table II. The qualified plans covered are listed in Appendix A and the non-qualified plans in Appendix B.
2. The sample for qualified plans is based on responses to a questionnaire sent to the 38 companies with qualified plans covered in our earlier Survey of 1981-1982. Nine of these companies had not responded by the closing date. Four of the responding companies advised that substantial changes had been made in the provisions of their plans - either conversion to a market plan or withdrawal of a discount feature -- during the 1983-1984 period. To avoid distortion, we omitted such responses, and limited our sample to the 25 plans in which there were no material changes during the period surveyed.

The sample for the non-qualified plans is too small to draw reliable conclusions. This is particularly so since it is distorted by unusually large cash option purchases in the second quarter of 1984 under the plan of one of the three companies. It is clear from the sample, however, that reinvested dividends of non-qualified companies do not follow the pattern of qualified companies in increasing in each successive quarter and that the average quarter-to-quarter increase for these companies during this period was only about 1%.

3. The principal conclusions which can be drawn from the Survey are:

- a. Reinvested Dividends.

Dividends reinvested in the 25 qualified plans in 1984 increased by 23.85% over the comparable figure in 1983. The percentage increase for 1983 over 1982 (based on the figures provided by the same 25 companies for our earlier Survey) is 35.17%. Our earlier Survey showed an increase for 1982, as compared with 1981, of 68.99%. In the three-year period during which the dividend reinvestment legislation has been in effect, reinvested dividends have, therefore, almost trebled.

Dividends reinvested in the 25 qualified plans in 1984 amounted to \$1,023 million, as compared with \$826 million in 1983, \$611 million in 1982, and an estimated \$361 million in 1981.

- b. Reinvested Dividends and Cash Option Purchases.

The total common stock capital provided in 1984 under the

25 plans amounted to \$1,150 million. This represented an increase of 15% over the comparable figure for 1983, 55% over the figure for 1982, and (using the conclusions of our earlier Survey) about 260% of the figure for 1981.

c. Quarterly Rate of Increase.

The average quarterly rate of increase in dividends reinvested under the 25 plans in the 1983-1984 period is 5.46% or more than five times the quarterly rate of increase for the non-qualified plan sample.

d. Percentage of Shareholders and Shares Participating.

In the fourth quarter of 1985, there were 886,454 shareholders participating under the 25 qualified plans. This represented 33.93% of the total shareholders of these companies. This 33.93% participation compares with 28.13% in the first quarter of 1983 and (using the conclusions of our earlier Survey) 19.61% in the fourth quarter of 1981.

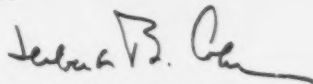
Share participation in the 25 plans in the fourth quarter amounted to 546,558,000 or 35% of outstanding shares. This compares with 29.46% in the first quarter of 1983 and (using the conclusions of our earlier Survey) 14.62% in the fourth quarter of 1981.

e. Shareholders Participating and Common Stock Capital Provided Under All Qualified Plans.

Extrapolating from the results of the fourth quarter of 1984, the 25 plans were then providing common stock capital at an annual rate of \$1.2 billion.

A number of companies, because of their reduced need for common stock capital, have converted or are likely shortly to convert, their previously qualified plans into market plans. Taking this into account, we estimate that the 25 qualified plans covered by this Survey represent about 30% of all continuing qualified plans. On that basis, we estimate that some 3 million shareholders are participating in continuing qualified plans, and that such qualified plans are providing common stock capital at an annual rate of approximately \$4 billion.

4. The results of this Survey further demonstrate the effectiveness of the dividend reinvestment legislation in achieving its stated objective of encouraging a material increase in savings, investment and new common stock capital formation where it is urgently needed. Such new common stock capital is being used to finance essential productive facilities which increases business fixed investment, national output and jobs.



Herbert B. Cohn, Chairman
Committee for Capital Formation
Through Dividend Reinvestment

TABLE I
TOTALS FOR 25 QUALIFIED COMPANIES

As of divi- dend date in	Rein- vested divi- dends (\$000) *	Cash option pay- ments (\$000) *	Total (\$000) *	No. of shares partici- pating (000) *	Total shares out- stand- ing (000) *	Shares partici- pating as % of total shares (%) *	No. par- tici- pating share- hold- ers *	Total share- hold- ers *	partici- pating share- holders as % of total share- holders (%) *
<u>1983</u>									
1Q	189,064	42,591	231,655	402,718	1,366,777	29.46	750,712	2,668,787	28.13
2Q	198,739	50,707	249,446	423,072	1,385,118	30.54	793,294	2,682,108	29.58
3Q	212,038	42,659	254,697	448,887	1,417,162	31.68	826,961	2,691,394	30.73
4Q	226,623	37,343	263,966	473,021	1,457,697	32.45	865,162	2,687,188	31.45
<u>Total 1983</u>	826,464	173,300	999,764						
<u>1984</u>									
1Q	235,971	36,723	272,694	487,096	1,482,265	32.86	855,763	2,672,903	32.02
2Q	250,528	34,937	285,465	512,072	1,506,995	33.98	871,021	2,659,523	32.75
3Q	262,835	25,967	288,802	533,319	1,542,124	34.58	876,262	2,642,750	33.16
4Q	274,216	28,359	302,575	546,558	1,561,588	35.00	886,454	2,612,409	33.93
<u>Total 1984</u>	1,023,550	125,986	1,149,536						

* If preferred were allowed to participate, response includes information relating to preferred participation in dividend reinvestment and cash option and to participation by preferred shares and shareholders.

TABLE II
TOTALS FOR 3 NON-QUALIFIED COMPANIES

As of divi- dend date in	Rein- vested divi- dends (\$000) *	Cash option pay- ments (\$000) *	Total (\$000) *	No. of shares parti- cipat- ing (\$000) *	Total shares out- stand- ing (\$000) *	Shares parti- cipating as % of total shares (%) *	No. par- tici- pating share- hold- ers *	Total share- hold- ers *	Partici- pating share- holders as % of total share- holders (%) *
<u>1983</u>									
1Q	1135	211	1346	3170	51449	6.16	7075	47579	14.87
2Q	986	211	1217	2440	52668	4.63	7101	46921	15.12
3Q	932	269	1201	2099	52229	4.02	6974	46865	14.88
4Q	1515	291	1806	3904	52411	7.45	6896	45660	15.10
Total 1983	4568	1002	5570						
<u>1984</u>									
1Q	1403	440	1843	3548	57919	6.13	6889	45642	15.09
2Q	1230	1452	2682	2914	58061	5.02	6941	45771	15.16
3Q	1121	196	1317	2582	58627	4.40	7177	47293	15.18
4Q	1097	193	1290	2663	58709	4.54	7139	47307	15.09
Total 1984	4851	2281	7132						

* If preferred were allowed to participate, response includes information relating to preferred participation in dividend reinvestment and cash option and to participation by preferred shares and shareholders.

APPENDIX A TO SURVEYQUALIFIED PLANS COVERED BY SURVEY

AMERICAN ELECTRIC POWER CO.
ATLANTIC CITY ELECTRIC CO.
BROOKLYN UNION GAS CO.
CAROLINA POWER & LIGHT CO.
CENTRAL MAINE POWER CO.
CENTRAL & SOUTH WEST CORP.
CINCINNATI GAS & ELECTRIC CO.
THE COLUMBIA GAS SYSTEM, INC.
COMMONWEALTH EDISON CO.
DAYTON POWER & LIGHT CO.
FLORIDA PROGRESS CORP.
IOWA ELECTRIC LIGHT & POWER CO.
IOWA RESOURCES, INC.
KANSAS POWER & LIGHT CO.
KENTUCKY UTILITIES CO.
MICHIGAN ENERGY RESOURCES
MIDDLE SOUTH UTILITIES, INC.
MINNESOTA POWER & LIGHT CO.
NORTHEAST UTILITIES CO.
NORTHWESTERN PUBLIC SERVICE CO.
OTTER TAIL POWER CO.
PUBLIC SERVICE CO. OF COLORADO
PUBLIC SERVICE ELECTRIC & GAS CO.
SIERRA PACIFIC RESOURCES
SOUTHERN COMPANY

APPENDIX B TO SURVEYNON-QUALIFIED O-I PLANS COVERED BY SURVEY

BANK OF HAWAII
KN ENERGY, INC.
MANUFACTURERS HANOVER CORP.

The CHAIRMAN. Charlie, I want to pursue the line of questioning I was pursuing with Ernie. I want to go back to my ideal world—well, not an ideal world—but take the assumption of no foreign competition. We bar it. We won't let it in. Also, we won't even let American capital invest overseas, if they wanted to do it for the overseas market. We are going to keep it here. It is not unlike what the situation in this country from roughly the Civil War to World War II. We raised most of our capital domestically—some came from outside, but we raised most of it domestically. We did not have any great foreign competition, and we weren't particularly a major player in foreign markets. Given those assumptions, what would happen in this country if we simply kept the present corporate profit tax level where it is now and got rid of the investment tax credit and got rid of all depreciation so that you really were stuck. You paid it out and you can't deduct it at all. Would they inevitably result in heavy industry simply disappearing or would they be able to raise the cost of their product to such a degree that they could still attract capital?

Dr. WALKER. In my judgment, the answer to your first question is that while heavy industry would not disappear there would be a significant cutback. In answer to the second question, it is assumed in a competitive society that if companies could have done so before, they would have raised their prices. Eliminating the ITC and accelerated depreciation and keeping the corporate tax where it is would have a drastic impact in two ways. First, the cost of capital would rise for those companies or the rate of return would fall. Second, cash flow would be drastically cutback.

The CHAIRMAN. What happens, though, Charlie, in this situation? You say no, they won't be able to sell their products.

Dr. WALKER. They will sell products. They will sell fewer products. They will be less efficient. They will find it very difficult to add new, more efficient equipment. Say a company was ready to put in a new robotics operation or whatever, and all of a sudden, they lost the cash-flow. In addition, the investment is not sensible any more in terms of cost, so the company will cut back modernization plans.

The CHAIRMAN. Let's take steel. Assuming that—with this protective society I have talked about—we are still going to lay rails for trains to run upon and we are still going to use steel and reinforced concrete, and unless we find some substitute that is provided by a much lower capital intensive industry—assuming we still need those things—why wouldn't capital flow to those businesses to provide those things, albeit it would be at a much higher cost?

Dr. WALKER. It will flow but at a much lower rate.

The CHAIRMAN. But would it flow at a rate sufficient to supply the market and demand for the goods?

Dr. WALKER. The market and demand for the goods is going to be cut back because of the higher price, the higher cost of producing those steel rails. You will still have everything going on, but a relative shift—from capital intensive to noncapital intensive activities. With commensurately less production of capital intensive goods, more inefficiency or less efficiency in producing them, and higher costs.

The CHAIRMAN. I can see that if you make the rails high enough, then it might favor the trucking industry which doesn't—which runs on concrete and that isn't reinforced concrete.

Dr. WALKER. That is a good example.

The CHAIRMAN. And that might happen. All right, now, let's take the other side—the other hypothetical—the same protected society. We now get rid of the corporate profits tax. So, it doesn't really matter whether you want to expense it or anything else. You are not going to pay any profits. Why doesn't that still favor the less capital-intensive industries?

Dr. WALKER. As discussed earlier, by implication, having a negative impact on investment and equipment.

The CHAIRMAN. I am assuming you can invest it if you want. You are not going to deduct—I mean, you are not going to pay any taxes on any profit you make, and assuming the same protectionism—nothing coming in from outside—why doesn't it have the same effect then?

Dr. WALKER. Let me walk through that in this way, as I think about it. If you eliminate the corporate profits tax, first of all, you have to look at the impact on all corporations. And the fact is that one way to look at the corporate profits tax is that we triple tax savings—not just double tax, triple tax. When the corporation earns its first dollar and the 46-percent tax is paid, it has after-tax income of \$54. If it doesn't pay all that out in dividends, that is saved, but it paid the tax anyway even though it saved the money.

The CHAIRMAN. But that is true of all corporations.

Dr. WALKER. Yes. Second, the corporation take the \$54 and invest that saving in productive equipment and machinery. When that earns a profit later, it is taxed. That is the second layer of taxation of corporate savings. And then, third, when it is paid out in dividends, the dividends are taxed to the stockholder. Removal of the corporate profits tax would completely eliminate all three of those layers of taxation and give a tremendous leg up to corporations to bid away capital from the rest of society. Corporations are not the only users of investment funds.

The CHAIRMAN. But what I am getting at, Charlie, is why doesn't it give an advantage to the businesses that are not so capital intensive?

Dr. WALKER. That is the second point. For capital intensive corporations involved, what will be happening here as a result of elimination of the corporate profits tax is, in effect, expensing of all of their new capital assets.

The CHAIRMAN. That is, in essence, what it is.

Dr. WALKER. Yes. It is more than that, but you could expense without eliminating the corporate profits tax.

The CHAIRMAN. But aren't you still going to have to attract more industry, if you are Bethlehem Steel than if you are Sears, Roebuck?

Dr. WALKER. Let me put it in this way. The disadvantage that a capital intensive company like Mr. Mercer's or a steel company or whatever has today versus a retailer or noncapital intensive company is that they have to make these huge investments in which the capital is recovered only over a long period of time. If you re-

cover it immediately through expensing, you have a level playing field.

The CHAIRMAN. I will reverse it. As long as we know what you mean by expensing. I know what you mean when you deduct it from your gross before you get to your net, but now, you are not going to pay any corporate tax anyway.

Dr. WALKER. OK.

The CHAIRMAN. So now, whether you decide to put \$200 million into a plant is not really determined by whether you can deduct it from your gross income because you are not going to pay any tax. So, now, to attract that \$200 million for the plant, you have got to compete with somebody else who, for the same \$200 million, can give you a higher rate of return.

Dr. WALKER. No, not necessarily give you a higher rate of return. That is a significant point there. Mr. Mercer would be in a prime position to compete with the noncapital intensive industries because he doesn't have to tie up his money for 10 or 15 years. Admittedly, a deduction of that over time gives him something back, but I should think there would be nothing better from his standpoint than to be shoulder to shoulder, on the same level playing field and with the same ground rules.

The CHAIRMAN. What you are saying then—initially Ernie said no, we can't compete in that situation. He then corrected himself later. What you are saying is, given no corporate profits tax, capital intensive industries will be able to compete for capital. It will not be the death knell of heavy industry in this country.

Dr. WALKER. I think it is quite the other way around. Economists for years have been saying that the corporate profits tax is a detriment to a new investment. I was almost convinced by these fellows this morning here that if you would raise the corporate profits tax, you would get a higher level of investment. That is absurd, but it is the ultimate end of the logic.

The CHAIRMAN. Do you have any word, Mr. Mercer, about attracting capital if there is no corporate profits tax?

Mr. MERCER. He is exactly right on. We would build the plant—the thing that I want to point out is that, sure, there are other industries that might give you a better rate of return than, say, our particular industry, but what is overlooked in these discussions is their degree of commitment by certain companies to the industry that they serve.

The CHAIRMAN. I don't really think they would give you a higher rate of return. Assuming there is a need for your product, I think your price level would reach a natural level in comparison with lower capital intensive industries, and you would get roughly the same return on your money, regardless of the kind of industry you put it into.

Mr. MERCER. It depends really on the risk. If you take a pharmaceutical industry, they have great returns, but they have great risks. So, we have to assess our risks in our various product lines in the markets in which we serve. But to have a no-tax situation simply would be—

The CHAIRMAN. You also phrase it very exactly. The pharmaceutical business is a risky business and you have a lot of money you plow into it, and you may or may not hit it. Therefore, to attract

money there, your inducement to them is going to have to be greater than in a less risky industry where the profit level is more level and more guaranteed.

Mr. MERCER. They would have a higher fertile rate than another would have.

The CHAIRMAN. That is correct, and in which case, you might have to guarantee them a higher rate of dividends, or you might have to guarantee them something that would cause them to say they would take a chance on pharmaceuticals because, if we hit it—if we hit it—the rate of return is going to be greater than if we invest in a regulated public utility.

Mr. MERCER. But, similarly, we find that when we invest in technology, which we have to do, we preserve jobs. And the fact that we invest more than our competitors shows up in our job retention and, in fact, in our job increases in our corporation.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman. I would like to, if I could, just followup on this line of questioning. It seems to me that last year we had an amendment that in effect, eliminated the corporate profits tax. And I think it was Senator Dole who suggested eliminating the tax on real estate, as a revenue raiser. And the Joint Tax Committee said that if real estate transactions were completely exempt from tax it might raise up to \$10 billion a year in the long run. And you know, the conclusion is that the reason it would raise \$10 billion a year is because the industry is so heavily subsidized. In effect they have a negative tax rate.

The CHAIRMAN. You are saying that we are a net loser on the subsidy?

Senator BRADLEY. We are a net loser.

Senator CHAFEE. That did include, as I recall, the mortgage interest deduction.

Senator BRADLEY. No, no. The mortgage interest deductions are not only sacred, but they cost a lot more than \$10 billion.

Senator CHAFEE. In the Dole suggestion?

Senator BRADLEY. No, that was just \$10 billion. That is just to say that we have been down that road. Let me ask each of the members if they agree with the following principles. Do you think any tax reform should not increase the deficit? Just yes or no. Dr. Walker?

Dr. WALKER. Yes.

Mr. MERCER. Yes.

Mr. O'BRIEN. Yes.

Mr. COHN. I think it should not increase the deficit.

Senator BRADLEY. All right. Do you think any tax reform should not increase the relative tax burden on middle- or low-income people? Dr. Walker?

Dr. WALKER. Yes. I would hope that you could work that out. Yes.

Mr. MERCER. Yes.

Mr. O'BRIEN. Yes.

Mr. COHN. I think that would be highly desirable.

Senator BRADLEY. Do you think any tax reform proposal should have the lowest possible rates for the greatest number of Americans?

Dr. WALKER. Yes, sir. I endorsed your rates in here earlier.

Mr. MERCER. Yes.

Mr. O'BRIEN. Yes, sir.

Mr. COHN. I think it would be desirable if it could be done consistently with the first point you raised—that is without increasing the deficit.

Senator BRADLEY. Yes. Do you think that any tax reform proposal—I know the answer to this—should be as neutral as possible among types of investment?

Dr. WALKER. Sir, I can't answer that yes or no because my definition of neutrality, I think, is different from yours.

Senator BRADLEY. Yes. We have heard today several definitions. [Laughter.]

Mr. MERCER. I don't know that I could answer that either.

Senator BRADLEY. OK. This is one that is beyond—

Mr. O'BRIEN. I am not sure I know the answer on this subject.

Senator BRADLEY. All right.

Mr. COHN. I would like to say that I do not agree with that.

Senator BRADLEY. You do not agree with it. OK. Again, just for the record—referring back to that Wall Street Journal article on tax lobbyists—Dr. Walker, just confirm for me. Do you represent the Aluminum Co. of America?

Dr. WALKER. Yes, sir.

Senator BRADLEY. Do you represent the E.I. DuPont?

Dr. WALKER. Yes, sir.

Senator BRADLEY. Do you represent Champion International?

Dr. WALKER. Yes, sir.

Senator BRADLEY. Do you represent Ford Motor?

Dr. WALKER. Yes, sir.

Senator BRADLEY. Do you represent Dresser Industries?

Dr. WALKER. Yes, sir.

Senator BRADLEY. OK. If I could ask Mr. O'Brien a question. On the capital gains question, is the thing important for you the differential?

Mr. O'BRIEN. Yes, Senator. The differential is an inducement and therefore it is very important to us.

Senator BRADLEY. So, the question is: How much of a differential?

Mr. O'BRIEN. Right.

Senator BRADLEY. I mean, obviously, the goal is no tax, but when I talk to people on the capital gains rate, there are two schools. One school says if you can get the top rate low enough, then the capital gains rate differential isn't that critical. And by low enough, they are talking about 25 percent, maximum 28 percent. Other people say that, no matter how low the rate is, you need some differential. And I wondered what you thought.

Mr. O'BRIEN. My judgment is that, irrespective of the rate, the differential is important to a person committing capital.

Senator BRADLEY. So, you would need some differential.

Mr. O'BRIEN. Yes, I do believe.

Senator BRADLEY. The Treasury plan has a top rate on ordinary income of 35 percent, and a flat rate on capital gains of 17.5 percent.

Mr. O'BRIEN. Right.

Senator BRADLEY. What if it was 25 percent?

Mr. O'BRIEN. The top rate?

Senator BRADLEY. No, no. If you kept the top rate at 35 percent, but you had a top capital gains rate of 25 percent.

Mr. O'BRIEN. I don't think that would be sufficient. What you are talking about is that you have gone down from 48 percent to 28 percent, then you are down to 20 percent. And it has worked well. And now, if you are going to boost it up to 25 percent, I think that you are going in the wrong direction, and you are not keeping enough of the differential.

Senator BRADLEY. OK. I wanted to ask just one other question on Mr. O'Brien's testimony. By the way, I find all of the witnesses' testimony on this panel extremely helpful—very thoughtfully researched—and I think it is very helpful.

Mr. O'BRIEN. Thank you.

Senator BRADLEY. On venture capital, your table 3, shows astounding numbers. Venture capital goes from 319 to 900 to 1,300, and in 1983 jumps to 4,500, I wondered, for the record if you cannot answer it now, if you had your source there as Venture Capital Journal, and maybe this is readily known or maybe it is not readily known. If you don't know it readily, I hope that you could tell the committee how they get those numbers?

Mr. O'BRIEN. OK. What I will do, Senator, is get both the background and how it is arrived at.

Senator BRADLEY. Yes. That is what I would like.

Mr. O'BRIEN. OK. I will get that for you.

Senator BRADLEY. Thank you.

[The prepared information follows:]

Venture Capital Journal: The source of the venture capital figures used in SIA's statement, defines the venture capital pool as the amount of capital committed to the organized venture investment community—private venture capital firms, small business investment companies and corporate subsidiaries. Venture Economics maintains a Venture Capital Resource Database which includes about 448 firms and provides information on type of fund, date funded, capital under management, geographic location, number of partners and associates, and investment focus. On the basis of information derived from these firms, Venture Capital Journal publishes detailed information on the industry. To the best of our knowledge, these are the most widely accepted and quoted figures on the size of the venture capital industry.

For further information, please contact Stanley E. Pratt, publisher, Wellesley Hills, Massachusetts.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. Mr. Mercer, I would like to refer you to the prior testimony that we had from the other panel, when we were discussing capital investment. The consensus seemed to be from the panel that, yes, it is important, but there are a lot of other things that are far more important, and that was indicated by our review of what the United Kingdom has from this chart. I don't know whether you had an opportunity to see this chart.

Mr. MERCER. No, I have not, sir.

Senator CHAFEE. Basically, it shows that the United Kingdom permits—75 percent of the capital investment to be expensed in the first year. In your particular industry, for example, you have—I don't want to refer to your company—but the industry as a whole has had a series of challenges, to put it modestly. I think that Mi-

chelin came up with a radial tire—or at least marketed one before the U.S. people did. You have very high labor rates in Akron, as the industry did as a whole. In your statement, you indicate that you would locate this plant instead of in Texas, perhaps in Canada, but isn't the truth of the matter—and I am not challenging you, I am asking you—there are a lot of other factors besides ability to depreciate your equipment that count?

Mr. MERCER. Oh, there are many factors. It has to do with the market. For instance, you take the United Kingdom—we happen to be in a tax-loss carry forward position there, so there you have the kind of situation you speak of, Senator Packwood, where we don't have a tax program. Our investment would be greater in the United Kingdom today if that whole European market were stronger, but it is not, and we are trying not to import tires from the United Kingdom into this country, although that is beginning to happen. But there certainly are other factors. The value of the dollar is one of the key factors.

Senator CHAFEE. But somehow the impression is—from your statement and from others—that the ITC, for example, is just crucial, and I am not so sure, as we look at the overall picture, that it assumes that high a role.

Mr. MERCER. Perhaps I am localizing it too much, but in my own business experience, where we develop hurdle rates on projects, the ITC takes us over the top if we go ahead with the project. Without it, we would have to either hunt for a place that would allow us to get to that rate, or we would abandon the project. I think the pipeline is a good example of that. We probably would not have done the pipeline. Perhaps someone else would have, but we would not have.

Senator CHAFEE. I am not speaking for the other members of the committee but just for myself. I am deeply concerned about the manufacturing segment of our economy, and we want to preserve that if we can. I am just not sure that these changes in the depreciation schedules are all that important, we had different testimony from Mr. Smith of General Motors, the president of Bethlehem Steel—but you give it great importance?

Mr. MERCER. Yes, I do, and I again refer you to my chart, which is history. That is not theory. And as investment spending goes up—triggered by the ITC—the jobs go up. And when ITC is taken away, the investment comes down and the jobs have followed as a result. So, yes, I do give it a great deal of importance.

Senator CHAFEE. In your statement, did you talk about the recapiture provision?

Mr. MERCER. Yes. I thought it was a rather onerous provision, and I hope it will be eliminated.

Senator CHAFEE. Do you have any idea of where we could make up this revenue?

Mr. MERCER. That is the big task that I think we are all faced with if we are going to keep this revenue neutral, and a bunch of us keep coming in here and saying but don't include that. I recognize that is a major problem, and I keep getting back to a couple of points. One is that we raise the rate from the 33 percent. We take that back up to a point that will make it revenue neutral, or we

figure out a way to stop spending. I think both of those might be—

Senator CHAFEE. I couldn't hear that. Stop what spending?

Mr. MERCER. Stop spending.

Senator CHAFEE. Well, we are working within this bill.

Mr. MERCER. I understand that if you can't lower the river, you have to raise the bridge, and I think that is what we are faced with.

Senator CHAFEE. That is like Dr. Walker's metaphor: Standing shoulder to shoulder on a level playing field. [Laughter.]

Dr. Walker, could you tell us where we might get the revenue? I think you voted yes on the question Senator Bradley asked—that you wanted this revenue neutral.

Dr. WALKER. Very definitely.

Senator CHAFEE. And now you have come with a rather major drawdown on the neutrality.

Dr. WALKER. On the President's plan—it wasn't my plan. No. I am commenting on his proposal to eliminate the investment credit and so on. If you were to keep the investment credit, for example, or try to keep it, is that it?

Senator CHAFEE. If we followed the Walker recommendations. As I recall, you want to keep the ITC.

Dr. WALKER. I basically want to keep something that tries to replicate the expensing of investment in new machinery and equipment, whether it is an ITC or you can do it through depreciation, or whatever. One way to do a little bit of that—not a dickens of a lot—is shift some money from the structures and inventory sector, which the administration has for some reason favored relative to machinery and equipment. The second way, is to raise the 33-percent corporate rate. I think for every point increase there you get \$3 or \$4 billion. If you went for a 37-, 38-, 39-, 40-percent corporate rate, that will move you in that direction. But overall, given the shakiness of this whole plan from a revenue neutral standpoint and the shortfalls that seem inevitable, it is going to be very difficult in my mind to keep it revenue neutral without looking for other sources of revenue.

Senator CHAFEE. Mr. Chairman, one last question to Mr. Mercer because the people he speaks for in his coalition are major employers and very important to our Nation in every respect.

Mr. MERCER. Yes, sir.

Senator CHAFEE. I am impressed by that. I am shaken by your list of where your facilities are and that you have no facilities in any of our States.

Mr. MERCER. We fly our blimp over your State quite regularly, Senator. [Laughter.]

Senator CHAFEE. But we would swap that for a plant. [Laughter.]

And we are glad you have come. That is what you call a tour that doesn't do much for us, though. It just flies overhead. What about Dr. Walker's proposal? We have had this suggestion before. I brought it up with the previous panels, and that is in their analysis of this, Dr. Fullerton, I think, said that schedules favor structures more than equipment. Somebody said that if you are a steel mill and you want to be competitive with Japan, you want your structure to be modern as well. But Dr. Walker has just suggested that

perhaps we could lengthen the depreciation on the structures and shorten it on the equipment. Now, that makes some sense to me, but what do you say to that?

Mr. MERCER. I would agree with that because it is the equipment inside the structure that determines how competitive you are and not the structure itself. Structures can be leased. You can do a lot of things with structures, but it is the basic equipment and the layout that determines how competitive you are going to be.

Senator CHAFEE. I suppose you can lease equipment, too. You would go for a lengthening of the period on the structures and a shortened period on the equipment?

Mr. MERCER. Yes, sir.

Senator CHAFEE. I think that makes sense. And you are speaking not just for your company but your colleagues?

Mr. MERCER. I hope so. I haven't asked the other 17 on that.

Senator CHAFEE. Well, we might hear from them on that. Thank you very much.

Dr. WALKER. Mr. Chairman.

The CHAIRMAN. Go ahead.

Dr. WALKER. I would like very much to add to Senator Chafee's point about the importance of the investment credit and what, to me, is one of the most salient aspects of the Ernie Christian's chart. I have a similar chart in my prepared statement. Senator Chafee said in the colloquy earlier that it seemed like the United Kingdom would be bliss from a capital recovery standpoint. Actually, Canada would be bliss under this sort of system, and let me explain one possible consequence and why the ITC and accelerated depreciation is so important.

Let us suppose that the Treasury plan passes. A couple of years down the road, a major automobile company has an outmoded plant. It is wearing out; it is old; it is inefficient. The company must have a new plant. They have the market, and they say, where are we going to build it—in Michigan, in Kentucky, in Texas, in Oregon, wherever? The chief financial officer says wait a minute. If we build it in the United States, we will get no investment credit, and we will have a period of 7 years to write off the machinery and equipment. If we go to Canada, we get a 7-percent investment credit, and we can write it all off—the machinery and equipment—within 3 years. Furthermore, we can produce automobiles in that cheap Canadian plant and sell them in the United States and pay a 33-percent tax on profits on our sales.

You are worried about the erosion of our manufacturing base. The Treasury proposal is an open invitation to this erosion. If you talk about South Korea where wages are much lower—then you really have no ball game.

The CHAIRMAN. Mr. O'Brien, let me ask you a question. In responding to Senator Bradley, you talked about the differential between the personal income tax rate and the personal capital gains rate.

Mr. O'BRIEN. Yes.

The CHAIRMAN. And what was the argument you were making? If the differential gets too small, people will not invest in stocks?

Mr. O'BRIEN. Yes. The differential is important as an incentive for people to invest for that purpose. So, that is—

The CHAIRMAN. All right. Let's take another hypothetical then. What kind of a differential would you need if we abolished the individual income tax?

Mr. O'BRIEN. I don't know the answer to that question.

The CHAIRMAN. Would you need one, or given that, would nobody buy capital stock?

Mr. O'BRIEN. I guess there are a lot of other reasons that might prompt them to buy or not buy the capital stock. I guess I can't go much beyond that, Senator. If there were no income tax at all—it is tough to say.

The CHAIRMAN. What caused them to buy capital stock before we had an income tax?

Mr. O'BRIEN. Basically, the reason the people will buy the capital stock—before 1913 or 1960 or today—

The CHAIRMAN. You could almost say before 1940, for all practical purposes because we did not have much of an income tax until then.

Mr. O'BRIEN. Right. I agree with you.

The CHAIRMAN. What caused them to buy it then?

Mr. O'BRIEN. People bought it for the possibility of profit over the long or short term, as the case may be.

The CHAIRMAN. But they didn't need a differential.

Mr. O'BRIEN. Well, that is a good question. I can only tell you that the reason I investigated in the past—to personalize it, which sometimes helps—I would make an investment in light of the existing tax structure that I faced at that time. There was a differential, and therefore I was induced and had the incentive to do it. If there was actually no tax, I guess I have never faced the issue. It is an academic question for me. I will be glad to think about it.

The CHAIRMAN. I was just wondering. It is my hunch that if you have got no tax, you put your money in an S&L and they promise you 8.5, 6, 10 percent—whatever the going interest rates may be—and you are trying to raise money for your company, and you are trying to do it on an equity basis, and you say, look, we think our company is going to do well. And we think over 5 years you will get a return not of 6 percent or 8 percent or 10 percent a year, but we think over 5 years we can guarantee 15 to 20 percent.

Mr. O'BRIEN. Right.

The CHAIRMAN. And the investor takes a look at you very hard and at the company very hard and says: Are you full of baloney or can you produce? And if they think you can, they will invest.

Mr. O'BRIEN. Well, I am willing to take the risk because I feel I may get a higher return over that 5-year period in your supposed case. I hope to get not only a higher return and pay a lower tax because I am at risk for the 5-year period.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you very much, Mr. Chairman. I would like to ask Mr. Aidinoff a question.

Mr. AIDINOFF. Yes.

Senator BRADLEY. Because he is really one of the outstanding tax lawyers in the country today. And I think maybe if it is OK with Mr. O'Brien—

Mr. O'BRIEN. Absolutely.

Senator BRADLEY. I would just like to ask him what he thinks is wrong with the present income tax system. I mean, do you see a need for lower rates and broadening the base—from your own experience?

Mr. AIDINOFF. I certainly believe that the present Federal income tax system can be improved substantially. It has a lot of unfairness built into it, and generally speaking, we would all be better off with a broadening of the base and with lower rates. I do not believe that that necessarily means that every item of income needs to be treated in the same way or that every item of deduction needs to be treated in the same way. And I think there are loads of items on which one can differ. I mean, certainly capital gains have been one of the areas where a lot of tax theorists and tax policymakers have thought that perhaps there ought to be a change. I think that the securities industry members, in their own analysis, believe—and I think the record will prove it—that we will not have the degree of equity investment by individuals unless we have a capital gains differential.

Senator BRADLEY. You know, the reason I asked that, Mr. Chairman, is that frequently when you go out and talk about tax reform, somebody in the audience says, well, those tax lawyers are all against you. But here we have a very prominent tax lawyer saying the system needs to be changed, and I think that is significant. The first thing that you said was that the tax system was unfair. How do you see that in your day-to-day work? I mean, how is it unfair? Is it unfair because equal incomes don't pay equal taxes, essentially?

Mr. AIDINOFF. I think, Senator, that over the last 10 or 15 years, we probably—our system has encouraged too many shelters. I think both your proposals, the Treasury I proposals, and the President's proposals—although to different degrees—accomplish some reform in that area.

Senator BRADLEY. So, in your practice, you have seen a few unproductive investments, done only for tax reasons?

Mr. AIDINOFF. I have seen many investments done for tax reasons, and certainly taxes have influenced the form of the investment and the type of investment. I think one can differ as to whether some of those investments are good or bad.

Senator BRADLEY. Thank you very much, Mr. Chairman, and I would like to thank the panel for their testimony.

The CHAIRMAN. It has been a most informative morning. Thank you very much.

[Whereupon, at 12:23 p.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF
THE FINANCIAL ANALYSTS FEDERATION
TO
COMMITTEE ON FINANCE
UNITED STATES SENATE

JULY 3, 1985

Introduction:

The Financial Analysts Federation is the professional organization for security analysts, investment managers and others in the investment decision-making process, with 15,000 members in the United States and Canada. Members are directly and indirectly involved in the investment of more than three trillion dollars of U.S. funds. The Federation offices are at 1633 Broadway, New York, NY 10019. Its phone number is 212/957/2875.

This statement to the Senate Committee on Finance has been prepared by the Federation's Government Relations Committee, which is chaired by Walter S. McConnell, CFA, of Houston, Texas. Mr. McConnell is a principal in the investment counsel firm of Vaughan, Nelson, Scarborough, and McConnell. He is a past chairman of the Financial Analysts Federation.

The Federation appreciates the opportunity to participate in the deliberations of the Finance Committee by submitting the comments below. Hundreds of the Federation's members specialize in specific industries such as machinery, chemicals, health care and office automation. If the Committee on Finance would care to discuss the impact of any part of the proposed legislation on a particular industry with these specialists, we would be glad to make the arrangements. Such specialists, we believe, would be among your most knowledgeable and objective sources of information.

Capital Formation:

The focus of our testimony is on capital formation. As much as any other factor, the capital formation process will determine the long-term growth of the economy, the rate of job creation, our success in controlling inflation,

and our ability to compete with foreign producers in both overseas and domestic markets.

Our analysis suggests that the dollar measures of capital formation would not change much as a result of the proposed legislation. However, the efficiency of the process should improve as investments are made more for economic reasons and less for tax reasons. The net effect of the proposed changes should be positive.

Capital Gains:

We strongly support the proposal to reduce the tax rate on capital gains. A tax differential on capital gains increases the rewards for entrepreneurship and risk taking - and it is risk investment that will best stimulate growth and enable us to compete with the Germans and Japanese as well as with South Korea and the other low-wage, emerging industrial nations of the Pacific Basin.

Venture capital investment has exploded since the maximum tax rate on capital gains was cut to 28% in 1978 (from 49%) and to 20% in 1982. Investment has advanced from \$400 million in 1978 (and considerably less in earlier years) to approximately \$2 billion in 1983.¹ Part of this increase resulted from the relaxation of pension trust investment rules in 1979, but investment by individuals and families also has experienced a quantum increase. Venture capital is particularly important for job creation since the majority of the jobs developed over the past decade have come in new and small businesses in fields ranging from high-tech applications to day care centers.²

A lowering of capital gains taxes also would improve the mobility of capital through the "unlocking" effect on investments held at low cost. This would facilitate the flow of funds to the fastest-growing areas of the economy,

1. Quoted from Venture Capital Journal & Asset Management Co. in Dec. 26, 1984, Salomon Brothers Inc. memo.

2. "Our entrepreneurial economy," by Peter F. Drucker in Harvard Business Review, Boston: January-February 1984, pages 59-60.

which is an essential function of a free market.

Another consideration is that a majority of our major industrial trading partners do not tax capital gains.³ Of ten leading industrial countries, Japan, West Germany, Italy, Belgium, The Netherlands and Australia have no effective tax on this form of income. Long-term capital gains are taxed at lower rates than ours in France and Canada and at higher rates only in the United Kingdom and Sweden. This difference in treatment may well translate into a long-term competitive disadvantage for U.S. companies and workers, particularly in high-risk businesses.

In contrast to the benefits that would be expected from a reduction in capital gains rates, there should be no penalty in terms of lost revenues. In 1978, the Treasury estimated that the lowering of capital gains taxes would reduce revenues by several billion dollars, whereas Congress indicated that it expected revenues from this source to increase. In actual practice, revenues rose by \$2 billion in 1979. Initially it was claimed that this was a temporary bulge reflecting a one-time unlocking effect. However, the increase has persisted and actually widened to \$3 billion in subsequent years, as a doubling of realized gains more than offset a decline in the effective tax rate.⁴ (See Table I.) For the current legislation, Treasury is estimating that the proposed changes will be revenue neutral, with an increase in realized gains offsetting the effects of a lower tax rate. (This concept of revenue neutrality is not stated in "The President's Tax Proposals.") The Treasury's estimates, however, together with the experience since 1978, seem to indicate that the benefits of a lower tax rate would not have to be paid for by a loss of revenue. In this one instance, at least, there would appear to be a free lunch.

3. Comparison of Individual Taxation of Long and Short Term Capital Gains on Portfolio Stock Investments and Dividend and Interest Income in Eleven Countries. New York: Securities Industry Association and Arthur Andersen & Co., June 1983.
4. Capital Gains in Adjusted Gross Income, Total Capital Gains and the Effective Tax Rate on Capital Gains (1954-1982) for Returns with Net Capital Gains. Washington, D.C., Office of the Secretary of the Treasury, Office of Tax Analysis, March 5, 1985.

Reduced Tax Rates on Individuals and Corporations:

We also support the proposed reduction in basic tax rates for individuals and corporations. For individuals, lower tax rates - and especially lower marginal tax rates - would encourage work, savings and investment. At the same time, it would reduce the incentives for tax avoidance and uneconomic allocation of resources. For corporations, lower rates would improve returns and therefore make new investment more attractive.

Retirement Plan:

The provision for individual retirement accounts (IRAs) begun in 1975 has been quite successful, with this pool of investment funds now amounting to \$160 billion.⁵ A substantial portion of these funds, moreover, apparently represents "new" savings as opposed to money that would have been saved in another form.⁶ This program also serves a valuable social purpose by making retirees less dependent on public assistance. The current proposal to expand the "spousal" contribution from \$250 to \$2,000 a year extends both of these benefits and we support this proposal. On the other hand, the proposed limitation on 401-K contributions will restrict the availability of investment funds. Although the sums involved are small, we consider this a step backward insofar as capital formation is concerned.

Dividend Credit:

The proposal to allow corporations to deduct 10% of dividends paid from income subject to tax represents a modest first step toward eliminating the double taxation of dividends. By reducing the penalty on dividend payments, this provision also would facilitate the flow of capital to areas where it can be used most productively.

-
5. Estimate for first quarter 1985 by Investment Company Institute. Reported in Mutual Fund News Service, June 1985. San Francisco: Green Communication, Inc.
 6. IRAS: The People's Choice: A National Survey of Individual Retirement Account Investment Practices and Preferences. Washington, D.C., The Research Department, Investment Company Institute, February 28, 1985, pages 46-49.

Capital Cost Recovery:

We have mixed views regarding the proposals to eliminate the investment tax credit and make depreciation writeoffs less generous. We recognize that these changes would generate large volumes of revenues to be used to finance tax reductions in other parts of the code. We also agree in theory with the "level playing field" concept and that lowering tax rates is preferable to subsidizing particular industries since this would relieve the Ways and Means Committee and Congress generally of the burden of setting industrial policy.

On the other hand, markets are increasingly global and the playing field is not level when foreign producers are included. Equipment writeoffs are faster in most other industrial economies.⁷ The extreme valuation of the dollar, moreover, represents a significant competitive disadvantage. While the dollar negative may prove to be temporary, any improvement may come too late to prevent a major permanent loss of market shares and jobs. Given the fragile state of the basic industry portion of our economy, we would suggest that existing incentives be withdrawn over a longer period than envisioned in the proposed legislation.

7. Study of the Relationship Between Liberality of Tax Write-off Provisions and Certain Measures Related to the Rate of Capital Investment. New York: The Financial Analysts Federation, January 1980.

TABLE I

Revised

Capital Gains in Adjusted Gross Income, Total Capital Gains
and the Effective Tax Rate on Capital Gains (1954-1982)
for Returns with Net Capital Gains

Calendar years	Gains in adjusted gross income	Excluded gains ^{1/}	Total gains	Estimated taxes paid on capital gains income	Estimated effective tax rate
	(\$ millions)				(percent)
1954	3,732	3,425	7,157	1,010	14.11%
1955	5,126	4,755	9,881	1,465	14.83
1956	4,991	4,692	9,683	1,402	14.48
1957	4,128	3,982	8,110	1,115	13.75
1958	4,879	4,561	9,440	1,309	13.87
1959	6,797	6,340	13,137	1,920	14.62
1960	6,004	5,743	11,747	1,687	14.36
1961	8,291	7,710	16,001	2,481	15.51
1962	6,821	6,630	13,451	1,954	14.53
1963	7,468	7,111	14,579	2,143	14.70
1964	8,909	8,522	17,431	2,482	14.24
1965	11,069	10,415	21,484	3,003	13.98
1966	10,960	10,388	21,348	2,905	13.61
1967	14,594	12,941	27,535	4,112	14.93
1968	18,854	16,753	35,607	5,943	16.69
1969	16,078	15,361	31,439	5,275	16.78
1970	10,656	10,192	20,848	3,161	15.16
1971	14,559	13,782	28,341	4,350	15.35
1972	18,397	17,472	35,869	5,708	15.91
1973*	18,201	17,556	35,757	5,366	15.01
1974*	15,378	14,839	30,217	4,253	14.07
1975	15,799	15,104	30,903	4,535	14.67
1976*	20,207	19,285	39,442	6,621	16.77
1977	23,363	21,974	45,337	8,104	17.88
1978	26,232	24,294	50,526	9,348	18.50
1979	31,331	42,112	73,443	11,669	15.89
1980	32,723	41,859	74,582	12,459	16.71
1981	34,713	46,225	80,938	12,684	15.67
1982	38,514	51,639	90,153	12,900	14.31

Office of the Secretary of the Treasury
Office of Tax Analysis

March 5, 1985

^{1/} 1954-1977: One-half of (net long-term gains - net short-term loss) for those with net gains.

*The excluded gains are estimated.

(Form 60)

1985
THE ADMINISTRATION'S TAX REFORM PROPOSALS AND PRIVATE CAPITAL
FORMATION

Testimony Presented

to

The Committee on Finance,
United States Senate

by

Norman B. Ture
President of IRET
(Institute for Research on the Economics of Taxation)

July 26, 1985

Statement of Norman B. Ture, President of IRET
(Institute for Research on the Economics of Taxation)
on
The Administration's Tax Reform Proposals and Private Capital
Formation
Presented to the Committee on Finance,
United States Senate
July 26, 1985

The Central Issue of Tax Reform

The broad-ranging and dramatic changes in the Federal income tax structure proposed by the Administration raise a great many issues that have been identified by the Committee and addressed by witnesses during these hearings. By far the most important of these from the point of view of the long-term progress of the U.S. economy is how these tax reform proposals are likely to affect the size and composition of the stocks of productive capital.

Every now and then it becomes fashionable to denigrate the contribution of growth in our production facilities and the efficiency of their use to the growth of our output potential. Unless the laws of production have been repealed or unless we have magically acquired a super abundant stock of capital, however, the amount and quality of the capital associated with labor services in production processes remains a critically important factor in determining how much labor is employed, and at what real wage rates. If changes in the tax structure slow the rate of addition to our stock of capital, the result will be a less productive labor force, lower levels of employment, lower

real wage rates, and less total output and income than otherwise would be obtained. And if those tax changes distort the allocation of capital resources among their myriad alternative uses, the same sort of results, although much less substantial in magnitude, will occur. How tax changes affect the growth in our stock of capital and the efficiency with which we use it is, therefore, a critically important criterion of the goodness or badness of these tax changes.

There can be no question that the Administration is abundantly mindful of these concerns in tax policy. There is, however, abundant reason to be concerned that the Administration's tax reform program would enhance, rather than reduce tax barriers to saving and capital formation and would intensify tax distortions of the composition of the economy's stock of capital.

Regarding the concern with the effect of the tax system on how large the nation's stock of productive capital is and how rapidly it grows, the Treasury has repeatedly acknowledged the basic bias of income taxation against saving and capital formation. Notwithstanding, the Administration has chosen to disregard changes in the income tax base that would move toward reducing, perhaps eventually eliminating, that bias: only the proposed modest increase in the limit on the deduction to spousal IRAs is an exception to this thrust of the proposed tax base changes, and this minor improvement would be more than offset by

the proposed taxation of the so-called inside build up of life insurance policies. Indeed, the only measures the Administration recommends that would be significantly pro-saving and pro-capital formation are the reductions in statutory tax rates for some individual taxpayers and for corporations. These rate reductions do not stand alone in the Administration's tax reform program; they would be financed by tax base changes a good many of which would further bias the tax system against saving and in favor of current consumption, and raise, rather than reduce, the cost of capital. The price that the Administration asks the American economy to pay for the benefits of lower tax rates is simply excessive.

Instead of addressing the basic tax bias against saving and investment, the Administration has focused its reform efforts on reducing tax-induced distortions of the composition and allocation of capital and additions thereto. The emphasis on inter-asset tax neutrality is certainly wholesome. Regrettably, the Administration's proposals, if implemented, would accentuate, not reduce, these distortions.

In short, the Administration's tax reform program would aggravate the existing income tax bias against saving and capital formation, thereby raising the cost of capital. It would intensify tax-induced distortions of the composition and allocation of investment and of the stock of capital. The result would be a smaller amount of capital, less effectively used, than if present law were maintained.

Assessment of the Proposed Capital Cost Recovery System

Although several of the provisions of the Administration's tax reform program bear heavily on the amount and composition of private capital formation, the chief of these are the recommendations to repeal the investment tax credit (ITC) and to substitute a so-called capital cost recovery system (CCRS) for the present accelerated cost recovery system (ACRS). Adoption of these recommendations, I believe, would be a serious mistake, a major step backward, a move away from the kind of tax treatment of capital recovery called for in the interests of achieving the optimum stock of capital and its most efficient composition and use.

Capital Cost Recovery and Tax Neutrality

A tax system that is constant with the requirements for economic efficiency and growth must be as nearly neutral as possible. Tax neutrality means that the tax system does not change the relationships among prices and among costs that would prevail in the absence of taxation. No tax system yet devised has ever been completely neutral in this sense. Realistically, the tax neutrality objective calls for minimizing tax-induced distortions of relative prices and costs.

To conform with tax neutrality an income tax system's capital recovery provisions must pass two tests. First, it must minimize the income tax's bias against saving and capital formation and in favor of current consumption. Second, it must minimize distortions in the market's valuations of different kinds of capital or of any particular kind of capital in differing uses or in the hands of differing taxpayers. The CCRS proposal fails both of these tests.

To pass the first test of tax neutrality --- minimizing the tax bias against saving and capital formation in the aggregate --- taxes must not alter the cost of acquiring and holding capital relative to the cost of consuming. To satisfy this condition capital outlays must be expensed, i.e., deducted in full in the taxable year in which the costs of the capital facilities are incurred, irrespective of the nature of the capital, who uses it, or in what kind of production.¹ Interestingly, a result equivalent to expensing may be

¹ See IRET Economic Report No. 25, "ACRS, ITC and Tax Neutrality," January 4, 1985.

achieved even with capital recovery allowances that are spread over an extended period of years after the costs of the capital facilities are incurred, provided that the present value of these allowances equals the prices of the facilities. This means, of course, that for any facility the total amount of the undiscounted allowances must exceed its price. It is not likely

that the designers of the ITC had this neutrality requirement in mind, but it is against this test of neutrality that today's tax policy makers should assess the ITC and the proposal to eliminate it. The present law ITC combined with ACRS may not insure that the present value of the combined capital recovery allowances precisely equals the prices of the facilities, but as has been shown, it does afford a reasonably close approximation thereto for most of the property for which the credit is available.²

² See IRET Economic Report No. 29, "Pluses and Minuses (Mostly) in the President's Capital Cost Recovery System," July 8, 1985.

There is, of course, an unlimited number of capital recovery regimes that would satisfy the test that the present value of the capital recovery allowances equals the price of the facility. For any particular facility, there is no one period of years over which recovery allowances must be spread, no one way of spreading the allowances over the period, and no one total amount of undiscounted allowances that meets this test. For example, suppose the price of a facility acquired the first day of the taxable year is \$1,000, that the appropriate discount rate --- the real after-tax rate of return generally available on production facilities --- is 4 percent, and that the inflation rate is zero. A single deduction of \$1,040 at the end of the first taxable year, a set of deductions of \$224.62 per year for 5 years, or a single deduction of \$1,216.65 at the end of the fifth year are merely three of a limitless number of combinations of

write-off periods and allowances per year that would meet the tax neutrality test.

The Administration makes much of the alleged need, in the interests of tax neutrality, to conform the capital recovery system as closely as possible with "economic depreciation." Economic depreciation is the change between two points in time in the present value of the remaining gross returns an asset is expected to produce. It is impossible, as a practical matter, to determine economic depreciation for any particular asset, let alone group of assets. Apart from this difficulty, there is no relevance in principle to the concept of economic depreciation as a constraint on the design of a cost recovery system in the tax law aimed at achieving tax neutrality, as shown above. In fact, even if it were possible to determine economic depreciation for any facility or group of facilities, implementation of this concept as the cost recovery system for tax purposes would certainly result in a serious shortfall of that system from tax neutrality.³

³ See Norman B. Ture, "The Accelerated Cost Recovery System: An Evaluation of the 1981 and 1982 Cost Recovery Provisions," in Charles E. Walker and Mark A. Bloomfield, Editors, **New Directions in Federal Tax Policy for the 1980s**, Ballinger Publishing Company, Cambridge, Massachusetts, 1984.

To satisfy the second, inter-asset tax neutrality test --- minimizing tax-induced distortions of the relative market values of capital facilities --- capital outlays must either be

expensed, or if an extended period capital recovery is to be used, afforded allowances the present values of which are the same percentages of the prices of all capital facilities. Expensing would satisfy both neutrality tests; it would impose no incremental tax on any capital, and it would, therefore, involve no difference in effective tax rates on income that is saved and invested, irrespective of the kind of capital that is acquired. If tax policy makers prefer or accept an incremental tax on capital generally, then they can assure that the same effective rate of tax is applied to all capital if the cost recovery system affords allowances the present value of which is the same fraction of the price for every kind of production facility.

The proposed CCRS meets neither of the tests of tax neutrality. The present value of the allowances it affords would fall short of the asset's price for every class of capital facility to which it would apply, and these present values would differ from class to class, systematically decreasing as the recovery period increases. As a consequence, CCRS would result in effective tax rates that systematically increase the longer the recovery period to which the facility is assigned. These findings are summarized in Table 1.

Table 1. Present Values of CCRS Allowances* and Effective Tax Rates, at Selected Inflation Rates.**

CCRS Class	Present Value of Allowances Inflation Rates			Effective Tax Rates Inflation Rates		
	0%	5%	10%	0%	5%	10%
1	\$0.93	\$0.91	\$0.89	3.2%	4.4%	5.4%
2	0.92	0.90	0.88	3.9	5.0	6.0
3	0.90	0.88	0.86	4.9	5.9	6.9
4	0.87	0.85	0.83	6.3	7.4	8.3
5	0.84	0.82	0.80	8.1	9.1	10.0
6	0.61	0.60	0.60	19.5	19.7	19.8

*Per dollar of capital at a real after-tax discount rate of 4 percent. It is assumed that the facilities are acquired and placed in service at the middle of the taxable year. Dollar amounts in the first taxable year are discounted for a half year, those in the second year a year and a half, etc.

**Effective rates computed at a statutory corporate income tax of 33 percent. Effective rate is defined as the percentage difference between the present value of the pretax gross returns required under the system of tax rules to warrant investment in the facility and the present value of the required gross returns in the absence of the tax. See IRET Economic Report No. 29, pp., 6-7, for a discussion of the concept of effective tax rates. Note that these effective tax rates are the rates of the incremental taxes on the returns to capital, because in the ordinary case the income which is saved and invested in the facility will itself have borne tax liability.

Inflation Adjustments in CCRS

One of the advantages claimed for CCRS compared with the capital recovery system in the present law is that the basis of depreciable property would be indexed for inflation in computing annual CCRS allowances. Inflation adjustments are certainly desirable to prevent inflation from eroding the real value of capital cost recovery deductions, hence imposing hidden, unlegislated increases in effective tax rates. But inflation indexing, per se, cannot overcome the fundamental deficiencies of CCRS. There is no question that the proposed basis adjustment

would moderate the adverse effects of inflation, but as Table 1 clearly shows, it would not prevent effective tax rates from being boosted by inflation nor would it significantly moderate inflation-induced differences in effective rates among asset classes.

The failure of the inflation adjustments of CCRS allowances to prevent inflation from increasing effective tax rates results from the fact that the indexing would not apply in the taxable year in which the property is placed in service. The Administration offers no reason for not allowing adjustment of the first year's depreciation for any inflation occurring during that first year. The consequence of this constraint is that inflation would be allowed to increase effective tax rates significantly.

The proposed inflation adjustments, moreover, would also be incomplete in that the accumulated inflation-adjusted allowances would fall short of the inflation-adjusted price of an identical replacement property. The reason for this shortfall is that only the current year's recovery allowance would be adjusted for the current year's inflation; prior years' allowances would not be adjusted upward to offset their erosion by inflation in subsequent years. For example, with an inflation rate of 5 percent a year, the inflation-adjusted price of a property that sold for \$1,000 would be \$1,276 five years later; the CCRS inflation-adjusted allowances, however, would aggregate only

\$1,065 for a CCRS class 1 facility written-off over the five years.

The Administration claims that with the reduced statutory tax rate and the inflation adjustments, the proposed CCRS would result in lower effective rates on virtually all depreciable property than result under the present ACRS-ITC system. The claim is correct providing inflation occurs at rates substantially higher than those that have prevailed in the last few years and are projected over the next several years. In fact, at a five percent inflation rate, the statutory corporate tax rates that would be needed with CCRS to prevent effective rates from exceeding those under present law would have to be much lower than the proposed 33 percent, except in the case of class 5 and class 6 property. At very low inflation rates, negative statutory tax rates would be needed if substituting CCRS for ACRS-ITC were to avert increases in effective tax rates for all equipment. Only in the case of structures would CCRS result in lower effective tax rates than those resulting under the present law's ACRS-ITC. These findings are presented in Table 2.

Another way of looking at this is to ask how high an inflation rate would be needed if the effective tax rates under CCRS with its proposed 33 percent statutory tax rate were not to exceed those under present law. Table 3 shows that except for property in CCRS classes 5 and 6, inflation would have to be much more acute than at present and, indeed, much higher than

generally projected, to keep the proposed tax changes from increasing effective tax rates.

Table 2. Statutory Tax Rates at Which CCRS Would Result in Effective Tax Rates Identical to Those Under ACRS-ITC*

CCRS Class	ACRS Recovery Period (Years)	Inflation Rates (Percent)	
		0%	5%
1	3	-99.0%	23.5%
2	5	-340.0	21.0
3	5	-160.0	18.5
4	5	-90.0	15.5
5	10	-3.0	40.7
6	18	35.4	49.2

*CCRS effective tax rates were computed with a 33 percent statutory tax rate. ACRS-ITC effective tax rates were computed with a 46 percent statutory tax rate.

Table 3. Inflation Rates at Which CCRS Would Result in Effective Tax Rates No Higher Than Those with ACRS-ITC

CCRS Class	ACRS Recovery Period (Years)	Inflation Rate (Percent)
1	3	6.9
2	5	6.8
3	5	7.5
4	5	8.6
5	10	3.3
6	18	■

*CCRS would result in lower effective tax rates at any positive inflation rate.

I certainly do not mean to belittle the desirability of adjusting the basis of depreciable property with respect to

inflation for purposes of computing capital recovery allowances. This indexing, however, should not be regarded as overcoming deficiencies in an inadequate cost recovery system. Indexing is not a substitute for a correctly designed cost recovery system.

How to Improve CCRS

The deficiencies in the CCRS proposal can be substantially overcome, resulting in a cost recovery system that would more nearly satisfy the requirements of tax neutrality. The objective to be sought by CCRS modifications is to achieve effective tax rates as close to zero as possible for every class of property and to insulate these effective tax rates as much as possible from the effects of inflation.

One simple way of achieving this objective would be to provide an investment tax credit for the property in each CCRS class. The rate of the credit would increase as the recovery period increases, and the basis of the property for purposes of computing CCRS allowances would be reduced by the full amount of the ITC. The adjusted basis of the property would be indexed for inflation, beginning at the time at which the property is placed in service.

If inflation were 5 percent a year, tax neutrality as defined in this discussion would be achieved with ITC rates shown in Table 4. Except in the case of structures, CCRS class 6, all

of these ITC rates are lower than those that now apply to ACRS 5-year property.

Table 4. Effective Tax Rates with CCRS and Multiple-Rate ITCs, at Selected Inflation Rates*

CCRS Class	ITC Rate	Inflation Rates			
		0%	5%	10%	20%
1	4.5	-1.3	0.0	1.1	3.1
2	5.1	-1.2	0.0	1.1	3.2
3	6.0	-1.2	0.0	1.1	3.2
4	7.3	-1.2	0.0	1.1	3.2
5	8.8	-0.8	0.0	1.2	3.2
6	17.4	-0.8	0.0	.7	1.5

*Calculated at a 33% tax rate with basis adjusted for the full amount of the ITC. A 4 percent real after-tax rate of return was used to compute present values of recovery allowances and effective tax rates.

Combining these modest ITCs with CCRS would not only fully achieve the goal of tax neutrality with respect to the consumption vs. investment uses of current income, it would also very substantially satisfy the test of inter-asset tax neutrality. Moreover, with this system, effective tax rates would be only moderately altered for any given class of property even with enormous inflation rates. Differences in inflation rates would have only the most modest impact in changing effective tax rates among the different property classes.

A very large ITC would be required for CCRS class 6 property (structures) if the goal of inter-asset neutrality were to be fully served. It is difficult to identify any reason why the principles and criteria for neutral capital recovery should not

apply to structures of all sorts, particularly if the revisions in the tax treatment of gains and losses on the disposition of depreciable property in the **President's Tax Proposals** were to be adopted. Changes in capital recovery provisions in the last several tax revisions have tended to widen the effective tax rate differential between machinery and equipment and other personal property, on the one hand, and real property, on the other. If the proposed tax reforms are thought to be efficient in eliminating or at least severely restricting the availability of real property tax shelters, there is little obvious reason to continue to bias capital recovery provisions against structures.

Conclusions

Much remains to be done if the federal income tax is to be purged of its bias against saving and capital formation and its distortion of the allocation of saving among the virtually countless types of capital and capital uses. The conditions that must be met to achieve these two tax neutrality goals are readily specified: the effective tax rates---properly defined---on the income produced by all depreciable property should be as close to zero as possible and should be as fully insulated from the effects of inflation as possible, and the differences in effective tax rates among different classes of property should be as small as possible. These conditions are not only readily stated, they may also be readily attained.

The inflation adjustments of the basis of production facilities for depreciation purposes proposed in the **President's Tax Proposals** is a step in the right direction, but in itself is not adequate to remedy the deficiencies in the proposed CCRS. These deficiencies could be very substantially overcome and a very nearly tax-neutral capital recovery system could be achieved by adding to the CCRS a multiple-rate ITC with full basis adjustment.

Without these modifications, the CCRS proposed by the Administration would be a seriously retrograde change in the tax law. In time, it would result in a significantly smaller stock of capital than would be attained if present law were continued, and contrary to the Administration's claims, that capital would be less efficient in terms of its composition and its production uses.

The modifications to CCRS that I've proposed would, I believe, avoid these unfortunate results. The principles these proposals embody, moreover, should be applied widely with respect to all productive capital, not only depreciable property. These principles should be applied in the case of natural resources and mineral properties, and a wide range of intangible assets. The more broadly applied, the more effectively will the private sector's saving be allocated among the countless capital uses to which saving is put in our economy.

With these modifications, substantial progress could be made towards the inter-asset tax neutrality which is emphasized by the Administration. No less important, these modifications would fortify the thrust, established by ERTA in 1981, toward restoring the growth in our economy's industrial base and our international competitiveness. The benefits in doing so would be found not only in a larger, more technically advanced and more efficiently used stock of business capital, but also in higher levels of employment, higher real wage rates, and higher levels of output and real income than we are likely to realize if the Administration's proposals in their present form are enacted.

TAX REFORM AND CAPITAL FORMATION

STATEMENT OF DAVID SILVER,

PRESIDENT

INVESTMENT COMPANY INSTITUTE

BEFORE THE COMMITTEE ON FINANCE

UNITED STATES SENATE

JUNE 20, 1985

I am David Silver, President of the Investment Company Institute, the national association of the American mutual fund industry. The Institute's membership includes 1,140 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. The Institute's mutual fund members have assets of approximately \$378.1 billion, representing about 90% of total industry assets and have over 20 million shareholders.

It is a pleasure to present testimony to the Senate Finance Committee on the topic of capital formation and tax reform. We commend Chairman Packwood and the other Members of the Committee for having undertaken the arduous journey on the road to reform.

Mutual funds have traditionally served as a vehicle through which investors of modest means may channel their investment dollars into the nation's economy through a diversified, professionally-managed pool of investments. We are, therefore, particularly mindful of the need to encourage capital formation while at the same time working toward simplification and reform of the Tax Code.

I first would like to focus my comments to the Committee today on an investment vehicle which has until now been primarily regarded as a retirement plan: the Individual Retirement Account (IRA). While serving as an effective source of retirement savings for all the working people of the country since its expansion in 1981, the IRA must also be viewed as an extremely important program for capital formation.

The significant contributions made to savings and capital formation by the IRA have been recently documented in a survey conducted this past year by the Institute. IRAs have boosted savings in recent years, and their contribution to savings will accelerate in the years ahead. At the end of 1981, when IRAs

were made available to all working individuals, the total pool of IRA assets consisted of only \$26 billion dollars. By December 1984, the pool had grown to \$132 billion with 23 million households owning IRAs. We estimate that the total IRA pool as of the end of April, 1985 will amount to almost \$175 billion.

The positive impact of the IRA on savings stems from two primary sources: (1) reinvested earnings generated by the expanding pool of assets just described, and (2) saving out of current income. At the beginning of 1983, for example, outstanding IRA assets totalled \$52 billion. If we assume that these assets earned a nominal 8.0 percent, approximately \$4.2 billion of new savings were generated during that year. In addition, we determined from our survey of the IRA market, that IRA owners -- through their 1983 contributions out of current income -- added \$10 billion to savings that would not otherwise have been made. In total, we estimate that IRAs added about \$14 billion to new savings in 1983. The comparable number for 1984 is probably over \$17.0 billion.

The growth of the accumulated IRA pool has a multiplier effect. As total IRA assets grow, new savings from earnings on these assets also grow. For example, we have further calculated that the new addition to savings from earnings on the IRA asset pool may be as much as \$37.0 billion dollars in 1989. These figures are based upon a projection that IRA assets could hit

\$550 billion or more by the end of the decade. This estimate is large even though the assumptions underlying it are quite conservative. The following chart summarizes the savings data:

YEAR	NEW SAVINGS GENERATED FROM IRA ASSETS (Billions of Dollars)	
	IRA ASSETS	NEW SAVING GENERATED FROM ASSETS*
1981	\$ 26	---
1982	52	2.1
1983	92	4.2
1984	132	7.4
1989	550+	37.0
(ESTIM.)		

* Assumes earnings on IRA assets at the end of the previous year will grow by an average of 8.0 percent.

The Institute's survey has demonstrated that the IRA must, in the future, be recognized both for its importance in promoting economic security in retirement as well as its accelerating contribution to capital formation. To further enhance savings and capital formation, the IRA contribution limits should be increased. For this reason, the Institute heartily endorses the

proposal in the Administration's tax reform package which would increase the spousal IRA contribution limits from \$2,250 to \$4,000 each year. This proposal would eliminate the existing discrimination against non-working spouses under current law and would permit both families with one wage-earner and those with two wage-earners to contribute as much as \$4,000 each year to IRAs.

The Institute believes that the IRA, as expanded in 1981 to provide universal coverage to all wage earners is a unique, simple and effective savings and retirement vehicle. The IRA may be easily understood and established with a minimum of paperwork and red tape. It is significant to note that of the 23 million households which own IRAs, two-thirds of these households have incomes under \$40,000.

Moreover, under its current structure and rules, IRA accountholders have complete freedom of investment choice. The Institute's survey shows that IRA participants have exercised this freedom of investment choice through a variety of financial institutions offering a broad selection of investment products.

The IRA market share breakdown at the end of 1984 is widely diversified:

<u>INSTITUTION</u>	<u>PERCENTAGE</u>
Commercial Banks	28.1
Mutual Savings Banks	6.4
Savings and Loan Associations	24.8
Life Insurance Companies	10.6
Credit Unions	5.9
Mutual Funds	12.1
Direct Investment in Stocks and Bonds	12.1

In contrast to the freedom of investment choice found in the IRA, the investment choice in employer-provided retirement and savings programs is more limited. In these programs, it is the employer who typically designates a single investment medium or institution or who permits his or her employees to select from a limited choice of investment media.

Unfortunately, the freedom of investment choice, which sets the IRA apart from other retirement savings programs and, indeed, the continued growth of the IRA asset pool itself, is threatened by a proposal buried in the Administration's tax reform package. This proposal would require that an individual covered by a

section 401(k) plan, a so-called cash or deferred arrangement, would have to offset his IRA contributions against the maximum dollar limitation on elective contributions which could be made to the 401(k) plan. In effect, many wage earners would be forced to choose between contributing to an IRA or making a larger contribution to their company's 401(k) plan.

The Institute opposes this type of offset provision as an oblique attack against the IRA which would have the ultimate effect of reducing IRA contributions. In addition, the 401(k)-IRA offset proposal strikes at the unfettered freedom of investment choice which is currently available to IRA participants. The offset proposal constitutes a type of governmental intervention which might permit an employer to skew the investment choice to the more limited selections offered under an employer's 401(k) plan. Moreover, a relatively simple, easy to administer savings and retirement program would, of necessity, become burdened with a new set of rules and cross-reporting requirements necessary to determine the amount of permissible IRA and 401(k) contributions for a particular year. A currently simple, uncomplicated program would become burdened with a maze of paperwork and uncertainty.

This indirect blow to the IRA savings program apparently has been justified as being part of a package to deal with issues

involving 401(k) plans. But the imposed linkage between IRAs and 401(k) plans is not a rational response to the perceived 401(k) problem.

To the extent that there may have been a concern that the non-discrimination coverage standards imposed upon section 401(k) plans have not been fully effective, the Administration's proposals would substantially revise and tighten these non-discrimination standards. Similarly, to the extent that there may have been a concern that 401(k) plans were used for short-term savings rather than retirement purposes, the Administration's package would restrict the use of loans and early distributions from 401(k) plans and other types of tax-favored retirement arrangements.

Unfortunately, the Administration's proposals regarding section 401(k) plans do not stop with specific cures for specific problems. In addition to restricting these perceived coverage and withdrawal inadequacies, the Administration's proposals impose maximum dollar limits on an employee's elective contributions to a section 401(k) plan. These annual limits, set at \$8,000, or possibly \$6,000 in combination with an IRA, represent purely arbitrary cutbacks which adversely affect the retirement savings purpose served by section 401(k) plans. In the context of the overall limits on contributions and benefits

and the non-discrimination requirements applicable to section 401(k) plans under the Administration's proposals, these arbitrary limitations serve no useful purpose. The Institute urges that any legislation addressing section 401(k) plans not include the limitations on elective employee contributions now contained in the Administration's proposals.

Turning now to another aspect of the Administration's tax reform proposals which would directly affect capital formation, I would like to discuss the Administration's proposed treatment of capital gains. Overall, the Institute, like our colleagues from the Securities Industry Association, supports the retention of a tax-favored status for capital investments. We believe that a lower effective tax rate on gains derived from the sale or disposition of capital assets, is a significant inducement to continued economic growth and capital formation. Thus we agree with the Administration's proposal to reduce to 17-1/2 per cent the maximum effective tax rate on net capital gains. We hope that the Congress and the Administration will maintain this tax treatment for capital gains as the legislative process, with its constant balancing of revenue concerns and tax burdens, moves forward.

In addition, we note with some concern that portion of the Administration's proposals which would permit certain taxpayers

to index for inflation the basis of their capital assets. Such indexing, which would presumably be coupled with ordinary income gain or loss upon the disposition of a capital assets, would be available only to individual taxpayers who chose to elect this treatment starting in 1991. Since the indexing election would not be available to corporate taxpayers, the individual shareholders of a mutual fund could elect between capital gain treatment and indexing for their mutual fund shares. However, under the Administration's proposal, the corporate shareholders of the fund would not have this election.

Moreover, the treatment of mutual funds and other pass-through entities is not entirely clear under the Administration's indexing proposals, as it appears that such entities may not be granted an indexing election. The hallmark of a mutual fund's taxation under Subchapter M of the Internal Revenue Code has always been an effort to place the person who invests through a mutual fund in a comparable position to a person who invests directly. The Administration's proposals run counter to this philosophy. Although an individual investor could index for inflation the basis of his capital assets, it is not clear whether the mutual fund, which operates as a pass-through entity, could do the same. If it could not do so, the individual mutual fund shareholder could index only the basis of his mutual fund shares, but not capital gain dividends. In that event, his tax

treatment under the Administration's proposal would not be comparable to that of the direct investor. If the Administration's proposal to permit an elective indexing of the basis of capital assets in 1991 is to be part of tax reform legislation, we urge that further consideration be given to the treatment of pass-through entities and the complexity rather than simplification that could result under this proposal.

To conclude my comments to the Committee I would like to briefly mention some tax reform proposals which are a direct concern to the mutual fund industry. Specifically, I am referring to a number of amendments to Subchapter M of the Internal Revenue Code which are designed to modernize and simplify those provisions of the Code which govern the taxation of mutual funds and their shareholders. Although the basic principles of Subchapter M have generally worked well for the mutual fund industry since their inception with the Revenue Act of 1936, some of these provisions have become obsolete.

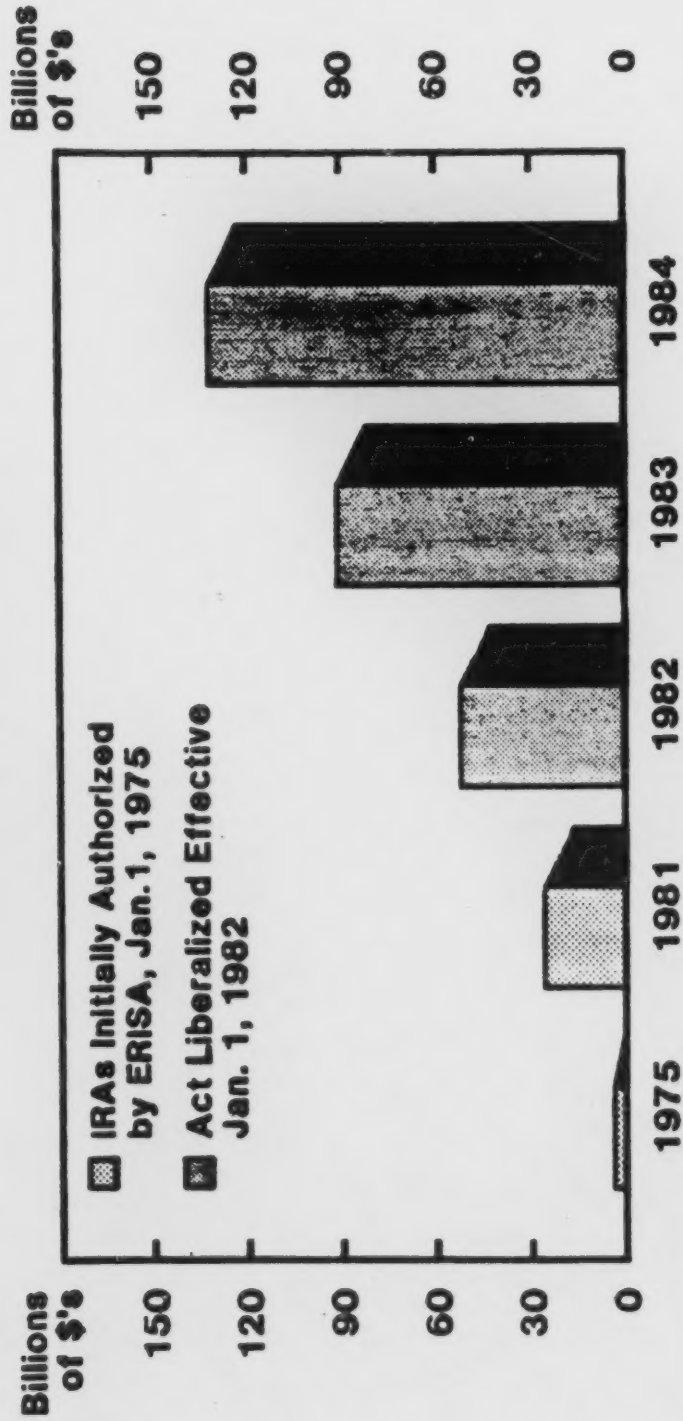
The recent changes in the financial markets which reflect increased volatility in interest rates, significant fluctuations in the stock market and the growing internationalization of the financial markets generally have led to the creation of a variety of new financial products, such as financial futures, index futures and options, exchange-traded options and options on

futures, as well as new investment strategies which make use of these products. While individuals investing directly may take advantage of these new investment products and strategies, certain outdated provisions of Subchapter M prevent the mutual fund from making use of these modern investment products and techniques on behalf of the investor who invests through a mutual fund.

The Institute proposes that the Congress remove or update these outmoded restrictions on mutual funds. In addition, the Institute proposes that the conduit treatment currently granted under Subchapter M be extended to permit a mutual fund to flow through to its shareholders both interest which would retain its character as interest and short-term capital gains. Such treatment is now permitted for long-term capital gains, tax-exempt interest and certain other items. The Institute believes that these amendments to Subchapter M, which have no significant revenue effect, are entirely consistent with the tax reform principles of simplification, fairness and growth. We urge the Committee to give their enactment serious consideration in this session of Congress.

We appreciate the opportunity to present these comments to the Committee.

IRA ASSETS OUTSTANDING, END OF YEAR



INDIVIDUAL RETIREMENT ACCOUNTS
HELP BOOST SAVING IN THE U.S.

MAY 15, 1985

ALFRED P. JOHNSON
VICE PRESIDENT &
CHIEF ECONOMIST
INVESTMENT COMPANY INSTITUTE
WASHINGTON, D.C.

In 1981 Congress enacted legislation broadening the eligibility criteria governing individual retirement accounts (IRAs). All taxpayers with earned income became eligible to participate in the program. One of the goals of this change was to help promote economic security in retirement, a national policy objective since enactment of the Social Security Program in 1935. Another key goal was to increase the volume of saving.

The rate of saving in the U.S. is low relative to savings rates in other industrial countries throughout the world (Table I). It is also low relative to our continuing need to encourage capital formation and to finance a continuing huge volume of public and private debt. Public policies designed to increase long-term saving would, therefore, help to keep inflation and interest rates at acceptable levels and stimulate growth in investment, production, and jobs.

It was quickly apparent that the new IRA program would enhance the retirement income of many individuals in low to moderate income groups. In contrast, the magnitude of the impact of IRAs on saving was not immediately evident. Now well into the fourth year of the expanded IRA program, however, its current and prospective contributions to saving are becoming clear. IRAs have boosted saving in recent years and their contribution to saving will accelerate in the years ahead.

MEASURING THE IMPACT
OF IRAS ON SAVING

IRA contributions to saving stem from two primary sources: (1) current income, and (2) reinvested earnings generated by the expanding pool of IRA assets. It should be emphasized at the outset that our estimates of the impact of IRAs on saving are not based on inferences drawn from changes in aggregate saving nor from variables only loosely related to such saving. Rather, they are derived from data which bear directly on activity in the IRA market.

Net Saving Out Of Current Income. The premise that IRAs have prompted people to save more out of current income is substantiated by data compiled in a survey of the IRA market conducted last November.* In that survey, respondents were asked a variety of questions relating to IRAs. One sequence of questions was specifically designed to help quantify the impact of IRAs on saving.

*The survey was conducted for the Investment Company Institute by Market Facts, Inc., a major market research firm. Approximately 5,000 questionnaires were mailed to a representative group of households and 3,487 were returned. Of that latter number, 965 were IRA owners and 2,522 were non-owners. The response rate was a high 70 percent and the income and age distributions of the sample closely match those of the U.S. population.

The first step was to estimate the sources of money used to finance IRA contributions in tax year 1983. The crucial element in this exercise is the need to distinguish IRA contributions which come from current earnings or other current income from those financed out of prior savings. To help insure accurate answers, respondents were instructed not to count dollars as prior savings if they came out of current income but were temporarily placed in checking accounts or other forms of saving during the year. Rather, such "pass throughs" should be regarded as current income.

When the responses were tabulated, we found that almost 6 in 10 respondents said that some part of the money contributed to their IRAs in the 1983 tax year came from current income. The balance came from different types of prior saving.

It is not enough, of course, to simply estimate the percentage of owners who said they used saving out of current income to finance their IRA contributions. If, for example, these contributions were simply a substitute for another type of saving, there would be no net addition to personal saving. In order to clarify this point, respondents were also asked: "had you not put your money in an IRA during the 1983 tax year, how would the money have been used?"

The answers break down like this. About half of the respondents said they would have saved it anyway. About 10 percent said they would have spent it all, while about 40 percent said they would have spent some and saved some. It is these

latter two groups that are the basis for our savings calculations.

From survey data, we estimated the average IRA contribution from each of these two groups. We then multiplied each of these averages by the appropriate number of households in the population. The final figures indicate that in excess of \$10 billion of total IRA contributions in tax year 1983 represented saving which would not have been made in the absence of IRAs. Our estimates of the impact of IRAs on new saving (and the spending-saving behavior of respondents) are not only intuitively reasonable, but they are similar to results obtained in a 1982 survey conducted by the Life Insurance Marketing Research Association.

New Saving Generated By IRA Assets. As we have seen, IRAs prompt some individuals to save more out of current income. The accumulated stock of IRA assets also generates earnings which are automatically reinvested (not spent). These earnings represent another important contribution to new saving.

Initially, the contribution to new saving from this source was obscured. The enormous popularity of IRAs, however, has increased assets and earnings to the point where they can no longer be ignored. As shown in the table below, moreover, growth in IRA assets is still in an early stage.

NEW SAVINGS GENERATED
FROM IRA ASSETS
(Billions of Dollars)

<u>YEAR</u>	<u>IRA ASSETS</u>	<u>NEW SAVING GENERATED FROM ASSETS*</u>
1981	\$ 26	---
1982	52	2.1
1983	92	4.2
1984	132	7.4
1989 (ESTIM.)	550+	37.0

*Assumes earnings on IRA assets at the end of the previous year will grow by an average of 8.0 percent.

In 1982, for example, it is estimated that savings generated from IRA assets totaled \$2.1 billion. This sum was derived by assuming that IRA assets at the end of 1982 (\$26 billion) earned a nominal 8.0 percent during 1982. This procedure was repeated for other years shown in the table.

Since IRA assets are in a sharply rising trend, saving generated from this source follows a similar course. By the end of 1989, IRA assets could hit \$550 billion or more and new saving generated from assets could total around \$37 billion.*

*The projection of IRA assets and new saving at the end of the decade reflects conservative estimates of: (a) The number of IRA owners; (b) The average annual IRA contribution by households; and (c) The average total return on accumulated assets. Our 1989 projections do not assume any significant changes in the current IRA program--either enhancements or restrictions. Such changes would, of course, alter the outlook.

Unlike our earlier estimate of saving out of current income, saving generated from assets does not take into account the possibility that households may have offsets to their accumulations. The reason for this is straight-forward: There is no quantitative basis for concluding that, in the absence of IRAs, households would have saved an amount equivalent to earnings on accumulated IRA assets. Nor, is there any conclusive evidence which suggests that households might actually reduce saving in other forms because they are achieving their retirement goals through the IRA program. Some offsets may well occur, particularly in the "out" years. Nevertheless, the net saving associated with earnings on accumulated IRA assets is likely to be significant.

The belief that all or most IRA savings are simply a replacement for other forms of saving greatly underestimates both the attractiveness of the incentives to save in an IRA and the deep-seated need of many people to attain a measure of financial security in retirement. The belief that people will actually reduce their rate of saving because of IRAs requires them to be highly rational and have a clear view of the future. These are textbook characteristics not found in most humans. In other words, the "offset" approach assumes that people have specific financial objectives (including dollar goals) and they regularly adjust their spending-saving decisions to achieve them.

In reality, many people allocate their saving to an IRA once a year. Having made their spending-saving decision, the dollars

enter a pool where they become relatively inaccessible. It strains the imagination to assume that people closely follow the amount of earnings (new saving) in their IRA accounts and reduce their other saving, accordingly.

It seems more likely that many people will let their IRA earnings "ride". Even if some of them save somewhat less out of current income for retirement, there are many other important savings goals. People continue to need more money to finance such things as: education; a home; emergencies, and travel. In short, it seems quite reasonable to expect that the rate of saving for retirement will be on the increase (because of IRAs) and saving for other purposes will, at least, hold its own.

Responding To The Skeptics. If IRAs are, in fact, making a net contribution to personal saving, why doesn't it show up in national savings statistics. Let's look first at what's happening to personal saving. Then, we'll try to explain why the impact may not be obvious.

As may be seen in Table II, dollar savings in 1984 are higher than in 1981 for the three concepts shown, but neither the levels nor annual movements are inspiring. The saving rate in the national income accounts, moreover, was 6.1 percent in 1984 (6.3 percent in the 4th quarter). This rate is probably not too different from the long-term average.

There are several reasons, however, why it is not easy to detect the impact of IRAs on aggregate saving. First, new savings associated with IRAs have--up to this point--been quite

small and they get lost in the aggregates. Second, aggregate savings estimates are by no means "carved in stone". Finally, other forces are at work beneath the aggregates which may be offsetting the positive contributions of IRA saving.

Lost In The Aggregates. Some feeling for the aggregate nature of national savings estimates may be inferred from the following brief description of the estimating procedures in the national income accounts. Personal disposal income (after taxes) from all sources is totaled--about \$2.5 trillion. Then, all types of personal spending are estimated. Saving is the residual--obtained by subtracting spending from income. Thus, all of the errors that are embodied in the income and expenditure areas are embodied in the savings numbers. The IRA market gets little, if any, separate attention.

Which Aggregate Should You Believe. The Federal Reserve also constructs savings estimates which are conceptually similar to the national income approach. The Fed, however, measures saving as the difference between the change in total assets and liabilities of key sectors in the American economy. Household savings are also determined as a residual. It is what's left over after the assets and liabilities of key sectors (for which information is available) are added together and subtracted from estimated totals.

In recent years, the difference between the two estimates of aggregate saving have ranged between \$50 billion and \$73 billion (Table II). In short, aggregate estimates are gross, suspect,

and don't deal with a tiny sector (tiny at this point) like IRAs.

Offsets In Other Areas. Finally, IRA contributions to total saving may be influenced by declines in other areas. For example:

- (a) The propensity to save may be influenced by the phase of the business cycle. In periods of expansion, people tend to spend more and save less.
- (b) The age structure of the population is shifting so that there are relatively more people in the age 18 to 35 group--a group which tends to save less according to life cycle analysis.

In summary, the impact of IRAs on saving appears to be positive, based on what we know about many details of that specific marketplace and the way people behave. If the contributions of IRAs cannot be detected in national savings statistics, it may be that the aggregates themselves are suspect or that other negative forces are offsetting their positive influence.

TABLE I
PERSONAL SAVING IN SELECTED COUNTRIES
RATIO OF SAVINGS TO DISPOSABLE INCOME

<u>YEAR</u>	<u>U. S.</u>	<u>FRANCE</u>	<u>GERMANY</u>	<u>UNITED KINGDOM</u>	<u>CANADA</u>	<u>JAPAN</u>
1970	8.0	16.7	14.6	9.3	5.3	18.2
1978	6.1	17.5	13.3	12.1	10.8	20.6
1979	5.9	16.2	13.9	12.9	11.3	18.7
1980	6.0	14.7	14.2	14.8	12.1	19.2
1981	6.7	15.6	14.9	12.5	13.8	19.7
1982	6.2	15.5	14.4	10.8	15.1	17.7
1983	5.0	(NA)	13.2	8.4	12.9	(NA)
1984	6.1	--	--	--	--	--

NOTE: Saving data for the U.S. are from the Economic Report to the President, 1985; the data for other countries are from the Statistical Abstract Of The U.S. 1985, page 435. NA means "not available."

TABLE II
THREE MEASURES OF SAVING*

YEAR	COL. 1 INCREASE IN ¹ FINANCIAL ASSETS	COL. 2 NATIONAL INCOME ACCOUNTS ²	COL. 3 FLOW-OF- FUNDS ACCTS ³	COL. 4 DIFFERENCE BETWEEN COL. 2 AND COL. 3
1980	\$326.3	\$110.2	\$165.3	55.2
1981	350.0	137.4	192.0	54.6
1982	369.9	136.0	209.7	73.7
1983	450.0	118.1	175.8	57.7
1984	498.9	156.8	204.6	47.8

*Data are compiled from the report, "Federal Reserve Flow-Of-Funds Accounts, Fourth Quarter 1984", page 53.

1 Increase in financial assets of individuals; these figures represent the combined change of households, farm business, and non-farm non-corporate business.

2 Personal saving from the National Income Accounts is the difference between disposable personal income and personal expenditures. Saving is a residual calculation and includes whatever errors are embodied in the estimate of income and expenditures.

3 Flow-Of-Funds saving is the change in asset holdings minus the change in liabilities. In the FOF, the household sector's holdings of such assets as corporate bonds, equities, etc. are inferred as transaction account residuals. Thus, to the extent that estimates of either the total amount of the asset outstanding or any other sector's holdings of the asset are in error, the household sectors inferred estimate will also be in error.

MACHINERY and ALLIED PRODUCTS INSTITUTE

1200 EIGHTEENTH STREET, N.W. WASHINGTON, D.C. 20036 202-331-8430

July 12, 1985

The Honorable Bob Packwood
Chairman, Committee on Finance
The United States Senate
219 Senate Dirksen Office Building
Washington, D.C. 20510

Dear Mr. Chairman and
Members of the Committee:

"Capital Formation" Aspects of the Reagan Administration's Proposals for Tax Reform

The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to present its views to the Senate Committee on Finance concerning "capital formation" aspects of the Administration's "tax reform" proposals.

SUMMARY

In our opinion, the President's "tax reform" package is detracting from the higher priority issue of deficit reduction. Also, the proposals would be injurious to U.S.-based manufacturers in an international competitiveness sense. Finally, the stated objectives of the program, namely, increased economic growth, more fairness, and tax simplification would not be achieved.

With particular reference to proposals that would affect existing targeted incentives to savings and investment (i.e., "capital formation"), the initiatives constitute a massive retreat. Accordingly, we advocate (1) retention of the Accelerated Cost Recovery System; (2) abandonment of the proposal to recapture accelerated depreciation; and (3) retention of the investment tax credit in its existing form, preservation of the basic mechanism in the event that action adverse to the credit is taken, and deferral of any negative changes in the credit until January 1, 1987.

PRESIDENT
CHARLES W. STEWART

VICE PRESIDENT AND TREASURER
THOMAS F. RUSSELL, Chairman
Federal Mogul Corporation, Detroit, Michigan

VICE PRESIDENTS
JOSEPH H. NEEDS, Chairman
Mott Corporation, Metairie, Louisiana
ROBERT CURE, Chairman and President
Cargill Industries, Inc., Houston, Texas
DAVID T. KIMBALL, Chairman
General Signal Corporation, Bedford, Connecticut

SENIOR VICE PRESIDENT
CHARLES I. DEER

SENIOR VICE PRESIDENT AND CHIEF ECONOMIST
RICHARD S. MASTRASS

VICE PRESIDENT AND SECRETARY
FRANCIS W. HOLLMAN, JR.

VICE PRESIDENT, LAW
WILLIAM J. HEALEY, JR.

ASSISTANT TO THE PRESIDENT
FRED E. SHAND

STAFF DIRECTOR, INTERNATIONAL
PAUL H. PRATT

STAFF COUNSEL
DONN E. MARSTON

ECONOMICS
A. B. VAN DER VOORT

EXECUTIVE COMMITTEE
WILLIAM F. ANDREWS, Chairman and President
Bovril Inc., Metairie, Louisiana
JAMES T. BEE, Chairman
Borg-Warner Corporation, Chicago, Illinois
WENDELL F. BUCHE, President
Alle-Chemco Corporation, Milwaukee, Wisconsin
A. WILLIAM CALDER, President
Arm Manufacturing Company, Pittsburgh, Pennsylvania
JOSEPH R. CARTER, Chairman
Western-Southern Company, Worcester, Massachusetts
J. PAUL CASEY, Chairman and President
J. Paul Casey Corporation, Erie, Michigan
J. E. CUNNINGHAM, Chairman
Balfour Beatty Corporation, New Orleans, Louisiana
CLARE DAUGHERTY, Chairman
Barnhart International Inc., York Beach, Maine
DONALD W. DAVIS, Chairman
The Granger-Walker, New Britain, Connecticut
THOMAS J. DOLAN, Chairman
A. G. Smith Corporation, Milwaukee, Wisconsin
NORMAN S. ELLSTROM, Chairman
Barnett Corporation, South Milwaukee, Wisconsin
FRANK W. EISENICH, Chairman
Superior Industries, Bedford, Illinois
T. MITCHELL FORD, Chairman
Fisher Corporation, Bedford, Connecticut
EDSON L. GAYLORD, Chairman and President
The Imperial Milling Machine Co., Bedford, Illinois
JAMES A. G. GIER, Chairman
Cincinnati Milacron Inc., Cincinnati, Ohio
K. ROBERT HARRIS, Vice Chairman
Case, Lupton, Inc., Santa Monica, California
THOMAS A. HOLMES, Chairman
Imperial Steel Company, Wheeling, Ohio, New Jersey
LEON C. HOLZ, JR., Vice Chairman
Air Products and Chemicals, Inc., Allentown, Pennsylvania
DEBORAH F. HUDSON, President
Machlett, Textron, Inc., Nashville, Tennessee
HERBERT W. JARVIS, President
Lubrizol Corporation, Wickliffe, Ohio
ROBERT V. KRIGORIAN, Chairman
Rexnord Inc., Brookfield, Wisconsin
QUENTIN C. KULEVSKA, President
Kammaran Inc., Lakeland, Pennsylvania
DONALD B. MELVILLE, President
Malco Company, Worcester, Massachusetts
GERALD B. MITCHELL, Chairman and President
Banco Corporation, Toledo, Ohio
JOHN C. MOBLEY, President
National Electric Company, Cleveland, Ohio
ALFRED G. MUGFORD, Sr., Vice President
Whit Combustion Industries, Inc., Cleveland, Ohio
JOHN J. HUBBARD, Chairman
Dresser Industries, Inc., Dallas, Texas
ELBERT H. NEESSE, Chairman
Balfour Beatty Corporation, Bedford, Connecticut
EARLE W. RICE, Chairman
The Federal Company, Federal, Massachusetts
WALTER F. RAAS, Chairman
and International, Harrisburg, Pennsylvania
PAUL G. SCHROEDER, President
Parker Hannifin Corporation, Cleveland, Ohio
HENRY D. SHARP, JR., Chairman
Baker & Brown, Inc., St. Louis, Missouri
RALPH E. SORENSON, Chairman and President
Barnhart Corporation, York Beach, Maine
RICHARD B. STONER, Vice Chairman
Commonwealth Company, Inc., Columbus, Indiana
JAMES R. STOVER, President
Extra-Correlation, Cleveland, Ohio
RAYMOND C. TOWNE, President
FMC Corporation, Chicago, Illinois
E. J. WEAN, JR., Chairman
Wean United, Inc., Pittsburgh, Pennsylvania
JOHN A. YOUNG, President
Haworth-Packard, Corona, Palo Alto, California



MACHINERY & ALLIED PRODUCTS INSTITUTE AND ITS AFFILIATED ORGANIZATION, COUNCIL FOR TECHNOLOGICAL ADVANCEMENT, ARE ENGAGED IN RESEARCH IN THE ECONOMICS OF CAPITAL GOODS (THE FACILITIES OF PRODUCTION, DISTRIBUTION, TRANSPORTATION, COMMUNICATION AND COMMERCE) IN ADVANCING THE TECHNOLOGY AND FURTHERING THE ECONOMIC PROGRESS OF THE UNITED STATES



MAPI and Its Interest

As the Committee may know, MAPI is the national organization of manufacturers of capital goods and allied products. The Institute and its affiliate, the Council for Technological Advancement, act as national spokesman for the industries so represented and conduct original research in economics and management. Apart from traditional capital goods product lines, MAPI's constituency includes leading companies in the electronics, precision instruments, telecommunications, computer, office systems, aerospace, and similar high technology industries.

The Institute's member companies produce highly engineered goods that are sold worldwide. Technological advancement is critical to the survival and growth of such companies. They believe that a continuing commitment to research and experimentation and dynamic programs of plant and equipment renovation, replacement, and expansion are fundamental to their ability to open and enlarge markets, sustain and create meaningful employment, and secure the defense. In our opinion, research is the "leading edge" of U.S. technological progression, and vigorous programs of capital investment are necessary to bring technology from the laboratory to the production line so that the full potential of new knowledge can be realized.

Thus, investment in the search for new knowledge complements investment needed to implement newly proven technology. There is no special incentive to innovate if there is no one to acquire and use the

fruits of the invention and one need not "modernize" if there is no new technology to apply. The competition for scarce national economic resources available through tax incentives may seem to pit companies and industries against one another. We submit, however, that there is a commonality of interest--national as well as private--in the business community, and that the dollars of national wealth allocated to research and capital are advantageous to all participants. This includes those individuals who have gainful employment or enterprises of their own that are derived from and survive as a result of a healthy U.S. manufacturing base.

Summary of Position

We commend the Administration and Congress for their interest in reviewing the U.S. federal tax system. A system as complex as the one under examination should be subject to more or less continuous surveillance to see that it operates as intended and to make adjustments, deletions, and additions, as needed. At the same time, we disagree with those who propose a massive and immediate overhaul of the system as compared to incremental change. Also, we feel that those who would incite a "groundswell" of public opinion in opposition to the revenue system currently in place will have little standing to complain if the results prove contrary to expectation. This does not mean that MAPI opposes reduction in personal and corporate income tax rates. Moreover, in our judgment, a shift of emphasis from direct to indirect taxation is long overdue.

"Capital formation" and taxes generally.--In looking at tax revision overall and "capital formation" in particular, we believe that the Committee should recognize that all taxes are costs of doing business and that tax increases or decreases directly affect the ability of taxpayers to save and invest. Consequently, the Committee may compartmentalize elements of tax reform proposals for its own convenience during hearings, but it should not treat the subjects in a narrow way when deliberating and arriving at decisions. Consider two examples: An international company that would be harmed in domestic and foreign markets by provisions that impinge unduly on the foreign tax credit limitations would be, to that extent, less able to invest. Also, an individual participating in a Code Section 401(k) cash or deferred arrangement who could not have access to his funds to overcome temporary financial hardship might be less likely to save.

The international perspective.--On another matter of possible general interest, we strongly feel that the Committee should review the U.S. federal tax system in an international perspective. Largely as a result of the serious federal budgetary deficits, high real interest rates, and the resulting unusual strength of the dollar, U.S.-based manufacturing companies--and undoubtedly companies in other sectors--are at a disadvantage vis-a-vis foreign-based companies in competing for business in domestic as well as international markets. With the growth of world trade and international economic interdependence, Congress no longer has the luxury of adjusting tax burdens in a vacuum. Whether the subject be "capital formation" or some other aspect of the Internal

Revenue Code selected for review, Committee members should consider each step of the way the extent to which any proposal will help or hinder U.S. taxpayers with foreign-based competitors. We will have additional views to offer with respect to international competitiveness aspects of the Administration's tax proposals at a later date in the current set of hearings.

The timeliness factor.--Another consideration is timeliness, which becomes relevant partly because of the condition of certain manufacturing industries and partly because of the economic outlook generally. Within the manufacturing sector, business has not yet recovered substantially from the last recession for many companies engaged in the manufacture of construction, mining, oil field, farm, and steel mill equipment, and has not been at all vigorous for many manufacturers of machine tools. Although it can be demonstrated that we have had a strong, investment-led recovery spurred by enhanced investment incentives enacted as part of the Economic Recovery Tax Act of 1981, the tax benefits in question have served in some instances only to keep certain industries from backsliding more rapidly due to an excessively strong U.S. dollar (as previously mentioned) and, in some cases, unrelated factors. Meanwhile, many U.S.-based companies that earlier enjoyed a vigorous resurgence from the recession now appear to have plateaued or reversed direction in such seemingly unrelated markets as those for semiconductors and heavy trucks.

The Committee should consider the consequences it might precipitate by shifting the tax burden significantly to business in 1986, with particularly severe restraints on targeted incentives for "capital formation."

Specifics.--Limiting our comments to what we understand to be the Committee's present focus on "capital formation," we have these recommendations to make:

1. Retain the Accelerated Cost Recovery System as is in the absence of any compelling need to cast it aside in favor of a new approach.
2. Abandon the proposal to "recapture" accelerated depreciation, which is really a penalty tax on capital investment already made.
3. Retain the Investment Tax Credit; consider ways to improve it; and, at the very least, keep the mechanism intact for future use if our recommendation is rejected.

More Specific Comments on Selected
"Capital Formation" Items

Capital Cost Recovery System

Under the Capital Cost Recovery System (CCRS) proposal, all depreciable tangible assets would be assigned to one of six classes, which would replace the present five ACRS recovery classes. Each CCRS

class would be assigned a declining-balance depreciation rate, ranging from 55 percent to 4 percent, and the depreciation rate would be applied to an asset's inflation-adjusted basis. To ensure that depreciation accounts close out in a reasonable number of years, each CCRS class would be assigned a recovery period of between 4 and 28 years.

CCRS depreciation schedules for each class would switch from the declining-balance rate to the straight-line depreciation method in the year in which, assuming a half-year convention, the straight-line method yields a higher allowance than the declining balance rate. Although a half-year convention would be assumed for purposes of determining the year of change from the declining-balance rate to the straight-line depreciation method, the first-year depreciation rate would be prorated based upon the number of months an asset was placed in service. Furthermore, a mid-month convention would be assumed for the month an asset is placed in service.

CCRS would adjust depreciation allowances for inflation by means of a basis adjustment. After adjustment for allowable depreciation in the prior year, an asset's unrecovered basis would be adjusted for inflation during the current year using an appropriate government price index. The applicable depreciation rate would be applied to the resulting adjusted basis. Inflation adjustments would begin with the second year in which the asset is in service.

There would be a full year's inflation adjustment in the close-out year if property is retained in service to the end of that year.

Retirement prior to the end of the close-out year would be treated as a disposition, upon which a taxpayer would recover the asset's remaining adjusted basis and recognize gain or loss. Retirements and other taxable dispositions would involve a pro rata inflation adjustment to basis in the year of disposition for purposes of computing gain or loss.

An asset's adjusted basis would be used in computing gain or loss upon disposition of a depreciable asset. The Administration proposes to tax all real gains on sales or dispositions of depreciable property as ordinary income, and losses from such transactions would be fully deductible against ordinary income.

Neither intangible assets nor assets eligible for cost depletion would be subject to CCRS. Foreign property would be recovered under a system of "real economic depreciation" that would not contain the investment incentives available to domestic property under CCRS, and indexation of foreign property would use the inflation rate of the taxpayer's functional currency.

Other parts of the proposal deal with such matters as earnings and profits computations; elective expensing of up to \$5,000 of personal property; vintaged mass asset accounts; safe-harbor repair allowance factors; leasehold improvements; a revived Treasury bureau to conduct empirical studies of economic depreciation and propose asset-classification and other changes; etc.

CCRS would be effective for property placed in service on or after January 1, 1986, and would have anti-churning rules.

Comment.--The CCRS proposal generally is much more progressive than the Real Cost Recovery System (RCRS) of the "Treasury I" initiative, but somewhat less advantageous than the existing Accelerated Cost Recovery System (ACRS) at low rates of inflation. However, this relatively benign assessment of CCRS evidently is valid only if one disregards the Investment Tax Credit (ITC) as a capital formation component working in conjunction with ACRS. Moreover, "equipment" does not fare well under CCRS relative to other assets. Treasury seems to believe that there is too much disparity under current law in effective rates for machinery and equipment compared to other forms of depreciable property.

In our opinion, the discriminatory treatment of equipment under CCRS does not accord with the high priority placed on equipment modernization by the tax law for more than 20 years since enactment of the ITC and institution of the guideline class life system of depreciation--both of which subsequently were enhanced by Congress. Treasury does not explain why equipment is the stepchild of its proposed new system apart from abstract references to "lack of neutrality" and "unsystematic distortions." We think that changes of this sort should be accompanied by more than vague references to abstract objectives or complaints in view of the fact that the priorities established earlier

by Congress for equipment modernization were not accidental or unintended. Indeed, we oppose this discriminatory treatment.

Certain other representations that give us pause are those implying that CCRS is simple, or, at least, very nearly as simple as ACRS. Without intending to quarrel with the system overall or the characteristics that in fact complicate it, we would call to the Committee's attention that CCRS would be a new cost recovery system superimposed on top of others--perhaps three or more--in use by many taxpayers. This is incremental complication to any unbiased observer. Also, CCRS features new asset classifications, a half-monthly convention for determining when assets are placed in service, exhumation of a defunct government bureau (previously known as the Office of Industrial Economics), indexation, and other new features. Further, one item of supposed "simplification" is accomplished at the disproportionate cost of having all income on the disposition of depreciable assets be characterized as "ordinary." If CCRS is to succeed ACRS, the Committee should consider elimination of some of the complexity.

Before accepting CCRS without ITC, we believe Congress should give consideration to where the proposed change leaves the United States relative to capital formation incentives employed by the major trading partners of this country. If the U.S. provisions are not competitive in an international perspective, then U.S.-based taxpayers will be disadvantaged in competing in both domestic and international markets.

According to a recent study by Arthur Andersen & Co.¹ to evaluate cost recovery allowances as a percentage of cost of assets for industrial machinery, equipment, and buildings in leading industrial countries, the United States ranked eighth out of the 16 nations included in the survey. It would appear to us from the amounts of revenues shifted away from targeted investment incentives by the Administration proposal that the U.S. ranking would decline as a result of "tax reform." See the attachment entitled "Treasury Tax Proposals Would Contribute to Already Massive Shifting of Production to Foreign Sources."

Pursuing yet another point, we note that the CCRS proposal is not nearly as brutal to affected parties as the prior incarnation known as RCRS. Indeed, we are told by Treasury that its CCRS proposal would only raise \$37.1 billion from businesses through 1990, according to government estimates, a trifling sum compared to the \$212.8 billion that would have been winnowed by RCRS during the same time frame. Considering that CCRS now has been scaled back, two questions arise. First, does Congress assist capital formation by removing \$37.1 billion from a targeted investment incentive and instead diverting it to a non-targeted application? Secondly, if CCRS has been rendered less potent, is it still sufficiently differentiated to justify the imposition of a wholly new system rather than making incremental improvements to ACRS?

¹ "A Comparison of the Cost Recovery Allowances for Machinery and Equipment and Industrial Buildings in Leading Industrial Countries with Similar Allowances in the United States," Arthur Andersen & Co., April 1, 1985.

We think not. MAPI urges that the Accelerated Cost Recovery System be kept in place.

We make available to the Committee two recent depreciation analyses by George Terborgh, MAPI Economic Consultant, entitled, "The Treasury Proposals [RCRS] on Tax Depreciation: A Massive Retreat," and "Historical Development of Depreciation Policy." A further analysis dealing specifically with CCRS is forthcoming.

"Recapture" of Accelerated Depreciation

Effective July 1, 1986, the Administration proposals would reduce the top marginal corporate tax rate from 46 percent to 33 percent and would reduce the top marginal rate for individuals from 50 percent to 35 percent. Prior to 1982, the top marginal rates were 48 percent and 70 percent for corporations and individuals, respectively.

According to the Administration, most taxpayers with substantial accelerated cost recovery deductions taken over the period 1980-85 will have been able to reduce tax at rates of 46 or 50 percent (48 or 70 percent for 1980-81). Furthermore, it is thought that these taxpayers generally expected to repay their deferred tax liabilities attributable to accelerated depreciation at the currently applicable 46 or 50 percent rate. However, because of the proposed reduction in tax rates after July 1, 1986, the deferred tax liabilities of such taxpayers generally would be repaid at a 33 percent rate instead of a 46 percent

rate for corporations (and at a 35 percent rate instead of a 50 percent rate for top bracket individuals).

In order to prevent taxpayers from obtaining the "unexpected windfall benefit," just described, 40 percent of a taxpayer's "excess depreciation" taken between January 1, 1980 and July 1, 1986, would be included in income over a three-year period. The excess depreciation over such period would be the excess of cumulative depreciation or amortization deductions over cumulative depreciation deductions that would have been allowed during such period using the straight-line method specified under current law for earnings and profits depreciation (i.e., Code Section 312(k)). For calendar year taxpayers, 12 percent of the excess depreciation would be included in income for the 1986 taxable year, 12 percent in 1987, and 16 percent in 1988. Appropriate adjustments would be made to this schedule for fiscal-year taxpayers to put them on the same basis as calendar-year taxpayers.

Taxpayers whose total depreciation deductions taken during the period in question are less than \$400,000 would not be subject to the rate-reduction recapture rule. Further, for those taxpayers who are subject to the rule, the first \$300,000 of excess depreciation would be exempt from recapture. If the taxpayer was in existence for only part of the 1980-85 period, the \$400,000 threshold and \$300,000 exemption would be adjusted accordingly.

Other provisions would apply to coordinate the recapture rule with net operating losses; determine the level of application with

certain business entities; and determine the source of amounts attributable to foreign property.

For calendar-year taxpayers, 12 percent of the excess depreciation would be included in income for the 1986 taxable year, 12 percent in 1987, and 16 percent in 1988. Appropriate adjustments would be made for fiscal-year taxpayers. Property subject to the recapture rule would include all property placed in service on or after January 1, 1980, and before January 1, 1986, for which depreciation or amortization deductions were allowable under current law for any part of the period January 1, 1980 through June 30, 1986. Transfers of property before July 1, 1986, in non-recognition transactions would be disregarded.

Other rules would deal with related-party transfers, and such transition rules as are necessary to prevent avoidance.

Comment.--We strongly disagree with the characterization of benefits derived from a rate change as being a "windfall," whether the taxpayer has deferred income or not. Moreover, we can think of no similar instance in recent tax history in this country in which such an expedient as the recapture proposal has been attempted.

As to the impacts, we would note that the recapture item punishes the same businesses that would be penalized from the outset by other changes adverse to capital formation. Further, the recapture evidently was layered on after some attempt by the Administration to withdraw from the anti-capital positions taken in Treasury I. The

result is nothing short of a double-whammy for capital formation during the recapture years.

Another strong objection we have to the recapture proposal is that it would place a drain on unrealized income in that no transaction would be required to give rise to the tax liability. If "fairness" has any meaning in tax policy, it surely is reflected in the idea that taxes generally should not become due before income is realized and taxable income is known to exist. We consider any deviation from this to be a dangerous precedent in the tax law, whether brought about with respect to recapture of accelerated depreciation or in other contexts.

Once established in the law in this manner, the recapture concept presumably would be extended by Congress to other "tax benefits" such as installment sales, research deductions, long-term contracts, etc. All such applications would be of questionable propriety and legality, and would cause enormous disruption if enacted.

Another question that arises here is whether the states also would impose taxes on recapture income. Of course, they could do so, subject to constitutional and other limitations similar to those that would confront the federal government. One might even think that they would be "inclined" to do so in view of erosion to their tax bases that will stem from other Administration proposals. Indeed, some may impose recapture automatically where they use federal taxable income as a starting point for computations.

Regarding one constitutional limitation, we believe that recapture would involve an ex-post-facto application of tax law entailing a taking of private property without due process. Although rate reduction effective prospectively would be the ostensible cause of the recapture, it would be measured by, and would only exist as a result of, a transaction entered into some years earlier. Further, the earlier transactions will have given rise to the tax deferrals to which recapture would attach, but this will have occurred in years when the existence of any recapture tax was not known. Whatever the legalities of the issue, taxpayers view it as unfair, and they clearly are justified in their evaluation.

Still another aspect of this would relate to the way that recapture would affect transactions that were dependent on tax benefits in place at the time entered into. For example, some such transactions have "penalty" clauses that take effect if the tax benefits believed to exist at the time of agreement do not materialize. How these arrangements would be affected would appear to depend on the degree of caution and foresight exercised in drafting the penalty clause and other relevant provisions. It stands to reason that contracts that were entered into in good faith and consistent with the law several years ago should not now be disturbed by a recapture tax that could not reasonably have been contemplated.

On an item of administrative detail, the proposal gives the impression that the recapture tax computation would be quite simple

because it relates to the Code Section 312(k) straight-line depreciation with which everyone presumably is familiar. Our understanding of this is that many companies do not maintain ongoing Section 312(k) earnings-and-profits computations, and generally have no need to do so unless their dividend payments might be from capital; they are engaged in certain types of tax-free reorganizations; or they have certain other non-routine purposes. Not only is the information not typically kept by many companies, but also we are informed that obtaining such data would be very burdensome and time-consuming.

Finally, with reference to capital formation, recapture would raise an estimated \$57 billion of revenue from business through 1990, according to Treasury. How could this fail to harm investment in the absence of offsetting incentives?

With due respect to the originality of the proposal and the imagination of its proponents at the Treasury Department, we find it defective and not worthy of further congressional attention.

Recommended Repeal of Investment Tax Credit

The Investment Tax Credit (ITC) has had a very checkered history, marked by suspensions, repeals, reinstatements, changes of rate, and basis reductions measured by ITC claimed in lieu of lower amounts. This sort of tinkering is not conducive to the operation of the credit as an incentive, but there is no doubt that the ITC has facilitated new investment at the margin. Now, the Administration

proposes to repeal the ITC in the interest of base-broadening, effective generally for property placed in service on or after January 1, 1986.

Comment.--Certain aspects of Treasury's case against ITC strike us as being of questionable validity. For one, we do not believe that the complexity of the tax law and the use of ITC in tax shelter offerings are valid reasons for repealing the credit. If ITC is an effective investment incentive and if repeal would put taxpayers at a disadvantage relative to foreign competition, then the higher priority should be assigned to the incentive.

Also, the existence of unused ITC carry-forwards is not a reason for repealing ITC any more than the existence of net operating losses is a reason for eliminating other tax credits and deductions. This is not to minimize the concern about carry-forwards, but rather to indicate that reduced profitability often will have such a result, and that it is the task of taxpayers and policymakers to consider alternatives for utilization rather than repeal of the benefits.

We find, also, that many companies that do not--or currently cannot--use ITCs themselves, still consider them important to their suppliers and customers, and incorporate the availability of ITCs into the marketing of their products. Indeed, most such companies expect to be profitable in time, in which case their own excess ITCs will be utilized.

Treasury seems possessed about the "inefficiency" of the Investment Tax Credit. We have heard many of the same arguments about the research tax credit, another credit that we support, and have found the objections to be rhetorical and largely specious. The ITC and the research credit are an important combination of incentives because it is research spending that leads to technological innovation and it is investment spending that brings new technology to production. Furthermore, both credits act as targeted incentives available to businesses of all kinds, large and small. To illustrate, bear in mind that farmers benefit from the Investment Tax Credit when they buy farm equipment; so do retail stores, road builders, etc.

According to Treasury estimates, repeal of the Investment Tax Credit would raise revenues of \$165.4 billion through fiscal year 1990. We have some reason to think, under the Administration proposal, that much of this amount will find its way into current consumption rather than investment in the facilities of production, distribution, transportation, communication, and commerce.

We have no hesitation in recommending that the ITC should be left in place to facilitate capital formation. However, given the pall that has been cast over this subject by Administration and congressional proponents of "tax reform," we recommend, at the least, that consideration be given to "improving" the ITC in some manner to allay the stated concerns of opponents of the credit, and that the mechanism be left in place for future use whatever is done.

Concluding Comment

To sum up, the "capital formation" provisions we have addressed in this statement under a narrow definition of the phrase would siphon \$259.5 billion out of businesses in the form of higher taxes, according to Treasury's estimates for fiscal years 1986 through 1990. The lion's share of the amount would be from repeal or diminution of incentives aimed at investment spending. In our opinion, this would constitute a massive retreat from existing policies that encourage capital formation.

* * *

We trust that these views will be useful to the Committee in its deliberations.

Respectfully yours,

Charles Stewart
P r e s i d e n t



MACHINERY AND ALLIED PRODUCTS INSTITUTE



Attachment

Treasury Tax Proposals Would Contribute to Already
Massive Shifting of Production to
Foreign Sources

The U.S. is experiencing a massive loss of capital goods and other manufacturing production to foreign plants, as well as the shifting of sourcing by U.S. firms to their foreign facilities. The United States will have a foreign trade deficit of about \$130 billion in 1984 and no improvement, and perhaps a worsening, is expected in 1985. Perhaps even more significantly, the deficit on current account will exceed \$100 billion in 1984 and no improvement in that account is expected in 1985.

A recent MAPI study, "The Capital Goods Recovery--Why Some Lag Behind," documented the extent to which, despite phenomenal growth in real spending in the United States for producers' durable equipment, the strong U.S. dollar and international market conditions have resulted in U.S. capital goods producers selling fewer capital goods here and abroad than they did in 1979. The principal conclusions of this study are as follows:

- In the first quarter of 1985, real domestic purchases of producers' durable equipment were 35 percent above the low recorded in the last quarter of 1982 and 19 percent above the previous record peak. However, worldwide (i.e., U.S. and export) sales of U.S.-produced equipment were only 19 percent above the recession low and only 3 percent above the all-time peak recorded in the final quarter of 1979.
- As for capital goods exports, between mid-1981 and late-1982, they declined by more than 25 percent and have increased only modestly (some 10 percent) from that level. Further, the share of U.S. capital goods production going into exports declined from 28 percent in the second quarter of 1980 to 22 percent in the first quarter of 1985.
- As for capital goods imports, they have increased significantly since 1967 both absolutely and as a

share of domestic purchases. In the five quarters since the beginning of 1984, capital goods (in real terms) were imported at a \$31 billion annual rate, representing 24 percent of U.S. purchases of producers' durable equipment. Significantly, during this period the trade balance in capital goods turned negative for the first time in many decades.

This trend in imports of producers' durable equipment is consistent with one which is emerging for purchases by capital goods firms generally. In September 1984, MAPI published the "MAPI Survey on Global Sourcing as a Corporate Strategy," which reflected the results of a survey of the global sourcing practices of 97 firms in the capital goods industries. Of particular interest, the survey found that, on the average, about 12 percent of those firms' domestic (U.S.) purchases come from foreign sources. The purchases include not only machinery and equipment but also a wide range of other manufactures as well as basic materials. The principal motivating force behind U.S. firms' purchases of capital goods abroad is an attempt to remain competitive by controlling costs.

Shifting of production to foreign affiliates.--Another side of the U.S. competitiveness problem--although one which cannot be documented so clearly--is the shift of sourcing for foreign markets from the United States to overseas manufacturing facilities of U.S. firms. That is, for competitive reasons U.S. firms are shifting to foreign sources (their own affiliates, licensees, and firms under contract) production for foreign markets which was formerly carried out in the United States.

Concluding comment on shifting of production to foreign sources.--Much of the business lost to foreign sources, affiliated and unaffiliated, may not return to the United States for the foreseeable future. The shifts which have taken place--due in large part, but by no means entirely, to the high value of the dollar--may become permanent because of the upgrading of the technology and the state-of-the-art production experience of the foreign producers. In addition to the cost advantages of many foreign locations, in those cases where heavy equipment and/or large projects are involved, companies may elect to centralize production of certain items--particularly those requiring extended financing terms--in countries where there is the prospect of more consistent export financing support than in the United States.

Capital goods orders lost currently also result in substantial losses of future business. Many orders for "big ticket" items, such as capital goods, are placed at infrequent intervals--in many cases at intervals of several years, or even a decade. When the initial order is lost to a foreign competitor, that competitor obtains the substantial business in repair parts and spares which follows for a number of years and also is more likely to be the favored supplier when there are additions to capacity. It should be noted that shipments of parts, which over a period of years tend to equal the dollar volume of the original equipment, do not normally require government-supported financing.

STATEMENT OF
MACHINERY DEALERS NATIONAL ASSOCIATION
BEFORE THE
UNITED STATES SENATE COMMITTEE ON FINANCE
JUNE 20, 1985

Machinery Dealers National Association (MDNA) is submitting this statement on behalf of its 500 MDNA member firms, all of which are small businesses that account for over 70% of the used machine tools sold in the United States. Because used capital equipment is acquired from large manufacturers and usually resold to small manufacturers, MDNA members are in the unique position to articulate the economic problems of the small business community. Our statement concentrates on a concern which we believe is shared by all small businesses: removal of the arbitrary and discriminatory ceiling imposed on the investment tax credit available to purchasers of used equipment and machinery. MDNA seeks fair and equal treatment of new and used equipment (large and small businesses) under our tax laws.

INVESTMENT TAX CREDIT FOR USED MACHINERY AND EQUIPMENT

Under present law, there is a \$125,000 limitation on the amounts of used equipment eligible for the investment tax credit, but there is no limitation on the investment tax credit available for new equipment. (This ceiling was to increase to \$150,000 in 1985, but due to a freeze established by the "Deficit Reduction Act

of 1984," this increase will not occur until 1987.) Similarly, the same carryback/carryforward provisions available for new equipment are not allowed to purchasers of used equipment who may not carryforward or carryback tax credits on investments over the limitation amount.

Since the original \$50,000 ceiling was established in 1962, the cost of basic, unsophisticated used equipment has generally increased by over 500%. It would cost over \$600,000 to start a small machine shop which would employ ten people. If a large company which could afford to buy new equipment purchased \$600,000 of equipment, it would receive an investment tax credit of \$60,000 (10% of \$600,000). If a small firm bought \$600,000 of used equipment, it would receive an investment tax credit of \$12,500 (10% of \$125,000). In addition, purchasers of new equipment can carryback three years and forward seven years that part of the investment tax credit on the \$600,000 purchase which cannot be used in the year of purchase. The small business which purchases used equipment can carryback and carryforward only the \$12,500 which is allowed as a result of the limitation. The \$475,000 in excess of the limit would receive no investment tax credit in any year. This example clearly illustrates the discriminatory impact on small business of this limitation.

Furthermore, an established manufacturer has hardly begun to retool before he realizes that the \$125,000 ceiling offers him very little assistance at all. The original arbitrary and

inadequate limit of \$50,000 was merely a token gesture to small business and in light of inflation, doubling the limit to \$100,000 thirteen years later, and to \$125,000 nineteen years later has perpetuated the injustice.

This discriminatory tax treatment impacts directly and primarily upon small businesses which are already hindered by their inability to externally or internally generate the capital necessary to buy equipment. Capital stock formation among small business (which may be the nation's best source of economic growth) has been impeded by high interest rates, restricted availability of credit, the government's regulatory burdens, and tax laws which discriminate against small business. Since small businesses cannot generally afford or justify new machinery, capital formation in this sector translates into the purchase of newer used equipment for start-ups or to boost productivity and expand the capacity of current business.

The Joint Economic Committee and the White House Conference on Small Business both have recognized the disparity between large and small businesses as they are affected by inflation and current tax policy. Both have called for tax measures targeted to small business that will enable smaller firms to retain a greater proportion of their earnings for reinvestment in capital improvements and plant expansion.

The current disparity between the investment tax credit available to new and used equipment is in effect a Congressionally

mandated discrimination against small business which directly dilutes the ability of small business to compete with large firms and survive. This disparity also allows new foreign machinery a competitive edge through the investment tax credit advantage over equally efficient and price competitive used domestic machinery. We assume this was not the original intent of the \$50,000, \$100,000, and \$125,000 ceilings.

In the 97th Congress, both the Senate and the House Small Business Committee identified the tax credit for used equipment as one of the top priorities in their capital formation and tax recommendations. When introducing his proposal to raise the current arbitrary limitation (S. 360), Senate Small Business Committee Chairman, Lowell Weicker, stated that "the substantial small business dependence on used equipment, particularly in this high technology environment, suggests that as a matter of simple equity for our Nation's small businesses the existing ceiling on used investment should be increased, if not removed entirely." (Emphasis added.) Senator Weicker's bill would have raised the ceiling from \$100,000 to \$250,000. He also urged the Finance Committee to phase in an elevation of the ceiling to reach \$500,000 by 1985. Senator Weicker concluded that "elementary justice" and the "improved productivity of our economy" required this basic change.

The importance of this issue is further evidenced by the fact that eight legislative proposals in the House and two in the Senate had been introduced in the 97th Congress, including Senator

Weicker's bill. Senator Bentsen introduced S. 1140 which was cosponsored by Senators Danforth, Baucus, Mitchell, and Chafee. That bill would have raised the limitation to \$250,000 and allow a carryback and carryforward of the cost of used equipment if it exceeds \$300,000 for any taxable year. Senator Bentsen stated that he believed "that an increase in the regular investment tax credit for used equipment is necessary to assure that the small businesses participate in the general upgrading of productive facilities which this proposal is intended to stimulate.... Finally, by allowing a carryover of any unused tax credit, we insure that businesses make the necessary investment this year without being deterred from making such investments due to the limitation on the amount of property qualifying for the investment tax credit." Senator Bentsen continues to be concerned about this issue. In the 98th Congress, he introduced a small business tax bill, S. 1840, that would have removed the limitation entirely.

Similarly, during the 97th Congress in the House, Congressman Bill Frenzel and Congressman Kent Hance introduced H.R. 1377 and H.R. 3759, respectively, both of which would have eliminated the limitation entirely. Congressman Tom Downey introduced H.R. 3644 which would have raised the limitation to \$300,000 and allowed a carryback/carryforward of the cost of used equipment in excess of that limitation for any taxable year. Congressmen Jimmy Quillan, Dan Marriott, Marty Russo, and Cecil

Heftel introduced bills which raise the limitation to \$500,000, \$300,000, and \$200,000, respectively.

We appreciate the efforts of these Senators and Congressmen in recent years to help on this issue. We are concerned that the mere raising of the limitation perpetuates the discrimination which is inherent in the current provisions of the tax code. The carryback three years and the carryforward seven years of the amount in excess of the limitation which was included in a number of these bills would have helped ameliorate this discrimination against small businesses.

In 1975 the Senate Committee on Finance reported out and the Senate passed a tax bill which would have eliminated the limitation entirely. In 1981, the Senate Finance Committee reported out a tax bill which eliminated the limitation and required a recapture of the tax credit computed upon the resale value of the used equipment. On the Senate floor this provision was removed from the bill and Senators Weicker and Durenberger succeeded in the passage of an amendment which raised the ceiling to \$125,000 in 1982 and \$150,000 in 1985. As indicated above, the increase to \$150,000 was postponed until 1987 by the "Deficit Reduction Act of 1984."

Our proposal for small business relief from the discriminatory limitation on the investment tax credit for used equipment and machinery has been supported by the Small Business Legislative Council (see Appendix A), the National Federation of Independent Businesses, the National Association of Wholesaler

Distributors, the National Small Business Association, as well as many other small business trade associations. In a poll conducted by the House Small Business Committee in the 97th Congress, this issue ranked in the top three of all small business tax priorities.

We commend the Senate Finance Committee for its support of our proposal in the past and urge that it give priority to passage of tax legislation which will eliminate the limitation during the 99th Congress. The benefits to our economy which can be derived from removal of this provision are: more competitive small businesses, stimulation of capital investment, development of creative and innovative products and processes, starting new businesses, helping small business maintain its market share and survive, expansion of capacity and productivity, increased employment, improved balance of payments, increased demand for new domestic machine tools, reduction in inflation, generation of more tax revenues, and equal opportunity for growth of all businesses.

We believe that small business is crucial to the survival of a free enterprise system. Small business is an effective force even in heavily concentrated markets, but its position is fraught with difficulties. The tax laws should not further handicap small businesses by giving tax breaks to industrial giants and denying such incentives to small businesses. We urge enactment of the 1981 Finance Committee proposal which eliminated the limitation and required a recapture of the tax credit computed upon the resale value of the used equipment. It would provide major assistance to small business in its capital formation efforts. In the alternative, MDNA supports total elimination of the investment tax credit because of the symbolic importance of the Senate going on record against discriminatory tax treatment of small business.

APPENDIX AINVESTMENT TAX CREDIT

The decline in our productivity is caused by several conditions. For the first time in twenty years, the Joint Economic Committee Annual Report of 1979 unanimously concluded that an increase in productivity is vital to the improvement of our economic standard of living and to the reduction of inflation. A partial cause of this situation is the antiquated production facilities of many American manufacturers. Another partial cause is the utilization of inefficient equipment; and yet another partial cause is the overall age of our country's industrial machinery. The most recent U.S. survey of machine tools shows only 11% of the industrial machinery in use today is less than five years old; 76% is at least ten years old. Equipment renewal and upgrading are necessary in both large and small manufacturing companies. Increasing productivity through equipment renewal is best achieved for small business through the purchase of affordable used machinery and equipment.

Under present law there is a \$100,000 limitation on the amount of used equipment eligible for investment tax credit, but there is no limitation on the investment credit available for new equipment. This discriminatory tax treatment impacts directly and primarily on small business which is already hindered by its inability to externally or internally generate capital necessary to buy new equipment.

In order to increase productivity and competition, the discriminatory ceiling on the amount of used property eligible for a tax credit must be eliminated; and, the carryover provisions available for new property must also be available for similarly situated used property. Traditionally, small businesses purchase used capital equipment; large businesses basically purchase newly manufactured capital equipment. The cost of obtaining capital for production equipment is high for everyone, especially those who cannot borrow at the prime rate. Firms purchasing used capital equipment do not have a chance to offset some of their costs through this tax credit. Confining the investment credit to only equipment with the latest technology helps primarily the largest enterprises and basically ignores the numerically greater small business segment of our economy which needs this tax credit the most. Because the small business sector offers the greatest potential for increasing employment, there is normally a direct relationship between increased installation of used machinery and increased employment.

RESOLVED

Small Business Legislative Council urges and supports changes in the IRS Code to allow a full investment tax credit for used machinery and equipment. This full investment tax credit will allow small businesses to receive the same tax incentive provided to big businesses and would allow small businesses to compete, to maintain their current market share, and to hopefully expand output and productivity.

The National
Small Business
Association Building
1404 K Street, N.W.
Washington, D.C. 20006
Telephone
(202) 296-7400

Small Business Legislative Council*

July 30, 1980

The position paper -- Investment Tax Credit -- is supported,
as of this date, by 51 members of the Small Business Legislative
Council:

- | | |
|---|--|
| American Assn. of MESBICs
Washington, DC | Direct Selling Association
Washington, D.C. |
| American Assn. of Nurserymen
Washington, DC | Eastern Manufs. & Importers Exhibit
New York, NY |
| American Metal Stamping Assn.
Richmond Heights, OH | Electronic Reps. Assn.
Chicago, IL |
| Assn. of Diesel Specialists
Kansas City, MO | Independent Bakers Assn.
Washington, DC |
| Assn. of Indep. Corrugated Converters
Washington, DC | Indep. Business Assn. of Michigan
Kalamazoo, MI |
| Assn. of Physical Fitness Centers
Bethesda, MD | Indep. Sewing Machine Dealers of America
Hilliard, OH |
| Automotive Warehouse Distribs. Assn.
Kansas City, MO | Intl. Franchise Assn.
Washington, DC |
| Bldg. Service Contractors Assn. Intl.
Vienna, VA | Local and Short Haul Carriers Natl Conf.
Washington, DC |
| Business Advertising Council
Cincinnati, OH | Machinery Dealers Natl. Assn.
Silver Spring, MD |
| Christian Booksellers Assn.
Colorado Springs, CO | Manufacturers Agents Natl.
Irvine, CA |

*Of the National Small Business Association



NASBIC

NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

1156 15TH STREET NW • SUITE 1101 • TELEPHONE (202) 833-8230

WASHINGTON, DC 20005

PRESIDENT
WALTER B. STULTS
EXECUTIVE VICE PRESIDENT
PETER F. BRADSHAW

OFFICERS

CHAIRMAN
WILLIAM R. THOMAS
CAPITAL EQUIPMENT DEVELOPMENT CORP.
JACKSON, MS

CHAIRMAN-ELECT
T. THOMAS WOODLIN
HARRIS CAPITAL CORP.
JACKSON, MS

VICE CHAIRMAN
THOMAS A. W. DALLAM
KRONENBERG CAPITAL CORP.
CHICAGO, IL

TREASURER
DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

SECRETARY
THOMAS W. WERTHEIM
HARRIS CAPITAL CORP.
JACKSON, MS

BOARD OF GOVERNORS

THE OFFICERS AND
DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

DAVID S. JONES
FIRST ADVANCEMENT CAPITAL, INC.
LOS ANGELES, CA

STATEMENT OF

WALTER B. STULTS

Before the

SENATE FINANCE COMMITTEE

June 28, 1985

SUMMARY OF STATEMENT

1. Long-term capital gains tax rate differential is essential factor for economic growth, especially for new and growing businesses.
2. Corporate capital gains tax rate should be lowered to parallel rate for individuals.
3. Special tax provisions for small business and incentives for investment in business growth should be maintained.

STATEMENT OF WALTER B. STULTS

National Association of Small Business Investment Companies

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

Thank you for this opportunity to present this statement on the Administration's comprehensive tax proposal.

I am Walter B. Stults, President of the National Association of Small Business Investment Companies (NASBIC), the national trade association which represents the overwhelming majority of all small business investment companies (SBICs).

Our members are privately-owned and privately-managed venture capital firms which provide equity capital and long-term loans to new and growing small business concerns. SBICs are licensed by the Small Business Administration and operate under regulations issued by SBA. Today, there are some 390 active SBICs with total assets of over \$2-billion. During the 26-year history of the program, SBICs have provided over \$6-billion in venture capital to about 70,000 small business firms.

The Critical Importance of Capital Gains Tax Rates

For SBICs, as for all other investors in American business, the level of Federal taxation of long-term capital gains is by far the most important provision in the Internal Revenue Code. Irrefutable evidence abounds: a meaningful differential between tax rates on ordinary income and those on long-term capital gains guarantees the essential flow of equity capital to entrepreneurs trying to start new businesses or striving to expand their existing operations.

The "Laffer Curve" has been ridiculed by many. I can't vouch for its overall soundness, but I can surely speak for the venture capital industry when I say that the reduction of taxes on long-term capital gains in 1978 produced more revenue for the Federal Government. The Treasury Department took its traditional position at that time and told Congress that the cut in such taxes would "cost" the Nation billions in tax revenues. But what actually happened? The Treasury has taken in more revenues from long-term capital gains in each year despite the cut in the tax rate on such income.

Remember, I am referring solely to the direct, or the "static" result of the cut: rates down, revenues up. I am not taking into account the "dynamic" impact of the reduction; that is, the additional Federal tax collections from the increased taxes paid by the businesses which received venture capital from our industry and equity capital from other investors.

On June 26, Don Ackerman presented testimony to your Committee on behalf of the National Venture Capital Association. His statement contained a number of charts and tables demonstrating the importance of venture capital to the birth and growth of innovative and job-creating companies -- and the direct correlation between capital gains tax rates and the supply of that venture capital. I shall not duplicate Mr. Ackerman's testimony, but I want to reiterate its validity and stress its essential role in our economic system.

NASBIC members were dumbfounded at Treasury I's frontal attack on the capital gains tax differential. We believed that

the near extinction of venture capital sources between 1969 and 1978 had shown the absurdity of removing incentives for institutions and individuals to invest in growth businesses. Fortunately, wiser counsel prevailed and Treasury II (or Reagan I) calls for a continued differential for long-term gains. NASBIC applauds that reversal and strongly urges your Committee to resist any effort to shave further the difference between rates on long-term capital gains and rates on other income.

Capital Gains Tax Rates for Corporations

While strongly supporting the President's proposal on capital gains tax rates for individuals, NASBIC calls for parallel treatment for corporations investing in new or growing small businesses. Over 90% of all SBICs are organized and taxed as corporations, so they will receive no incentives from the Reagan measure. As a matter of fact, corporations providing venture capital have fallen behind in the tax area since 1978 when the rate on long-term capital gains was set at 28% for both individuals and corporations. The rate for corporate taxpayers remains at 28% today in spite of our urging since 1981 that the rates should be the same for both individuals and corporations.

The proposal you are considering actually would reduce somewhat the attractiveness of venture capital investments for individuals as well, since the exclusion would be cut from 60% to 50%. Today's differential for the highest paying individual taxpayers is 30%; under Reagan I, the difference would be cut to

17.5%. But look at the corporate side of the coin: today's differential is 18%; under Reagan I, there would be only a 5% difference between corporate tax rates on ordinary income and on long-term capital gains.

NASBIC strongly believes that this tiny differential will cause corporate taxpayers to curtail their investments in venture capital firms and in venture investments. This result will have a serious adverse impact not only on the SBIC segment of the venture capital industry (which is overwhelmingly corporate in form), but also will drastically reduce the flow of capital from corporations to the other segments of our industry. Stanley Pratt, publisher of Venture Capital Journal, estimates that more than 40% of all the capital now committed to the venture capital industry either comes from corporate investors or is held by corporate venture capital companies.

We urge your Committee to amend the President's proposal to establish parallel tax rates on long-term capital gains for corporations and individuals. Based on recent empirical evidence, we are convinced that this change will produce increased tax revenues for the Federal Treasury.

Other Features of Importance to Small Business

At this point, I should stress one basic fact of life to every venture capitalist: no one in our industry can survive, let alone prosper, unless the small businesses in which we invest can thrive. Venture capital firms are minority investors in

high-risk, high-potential entrepreneurial enterprises. We have to worry about taxes only if the companies in our portfolios grow and become profitable.

The Tax Act of 1981 marked a milestone for this Nation's entrepreneurs; it allowed them to plow back more of their revenues and their profits into their businesses. The liberalized and simplified depreciation schedules permitted them to utilize more of their cash flow for creating new jobs and expanding their productive capacity. In addition, incentive stock options allowed these firms to attract highly-qualified personnel, even though they could not match the salaries and fringe benefits offered by larger established competitors.

Unfortunately, the tax laws enacted in 1982 and 1984 reversed the pro-growth philosophy of the 1981 Act and Reagan I would restrict the viability of growth businesses even further. I grant that the reduction in the top corporate bracket from 46% to 33% is attractive, and we applaud the retention of the graduated corporate tax rate. On the other hand, we believe that the removal of the other incentives for reinvestment and growth exacts too high a price for that cut in the top rate.

Conclusion

Throughout this statement, I have tried to point out that tax incentives for economic growth are a wise investment in the Nation's future. Such concepts as "simplicity", "neutrality" and "level playing field" sound plausible, but the small business

community generally and the venture capital industry in particular call for tax laws which create an environment in which young and growing firms can create jobs, produce innovative goods and services, and foster competition. We call for tax laws which promote vigorous economic growth. Everyone wins in such a situation -- even the tax collector.

Stockholders of America, inc.



INVESTORS
IN
AMERICA

THE VOICE OF 32 MILLION

1625 EYE STREET, N.W.

WASHINGTON, D. C. 20006

(202) 783-3430

OFFICE OF
THE PRESIDENT

STATEMENT FOR
THE COMMITTEE ON FINANCE
U.S. SENATE

99TH CONGRESS

By

MARGARET COX SULLIVAN
PRESIDENT
STOCKHOLDERS OF AMERICA, INC.
WASHINGTON, DC

JUNE 20, 1985

A NATIONAL NON-PROFIT NON-PARTISAN ORGANIZATION
ESTABLISHED 1972

51-220 351

MR. CHAIRMAN AND MEMBERS OF THIS DISTINGUISHED COMMITTEE:

I WANT TO THANK YOU FOR THE PRIVILEGE TO EXPRESS OUR VIEWS ON THE PRESIDENT'S TAX PROPOSALS IN BEHALF OF STOCKHOLDERS OF AMERICA. WE ARE GRATEFUL TO THE COMMITTEE FOR THE READINESS AND THE WILLINGNESS TO GIVE ITS THOUGHTFUL CONSIDERATION TO TACKLE THE NEEDED OVERHAUL OF OUR PRESENT TAX CODE. I AM MARGARET COX SULLIVAN, PRESIDENT OF STOCKHOLDERS OF AMERICA, THE NATIONAL NONPROFIT, NONPARTISAN ORGANIZATION REPRESENTING THE INTERESTS OF OVER 42 MILLION STOCKHOLDERS IN AN ESTIMATED 13,500 PUBLICLY HELD AMERICAN CORPORATIONS.

CERTAINLY FAIRNESS AND GROWTH ARE FUNDAMENTAL TO THE NATIONAL WELL-BEING; THEREFORE, THE REDUCTION IN THE PERSONAL TAX RATE IS OF UNPARALLELED IMPORTANCE AND, OF COURSE, WELCOME. SINCE STOCKHOLDERS ARE A VARIED AND DIVERSIFIED GROUP, THIS LIFTING OF SOME OF THE TAX BURDEN WILL HAVE A FAR-REACHING EFFECT THROUGHOUT THE COUNTRY. INDIVIDUAL STOCKHOLDERS WILL HAVE MORE FREEDOM TO CONTROL THEIR OWN MONEY, BE ABLE TO SAVE MORE, AND INCREASE THEIR INVESTMENTS. IT MUST BE UNDERSTOOD THAT STOCKHOLDERS ARE NOT JUST A FEW OF THE SO-CALLED RICH. THE LAST NEW YORK STOCK EXCHANGE STUDY (1983) REVEALED THAT 33 PERCENT OF THE STOCKHOLDERS HAVE AN ANNUAL INCOME OF LESS THAN \$25,000; 63 PERCENT OF THE STOCKHOLDERS HAVE STOCK PORTFOLIOS VALUED AT LESS THAN \$10,000; THE MEDIAN PORTFOLIO IS \$5,100. MAYBE THAT'S WHY THEY ARE CALLED "THE LITTLE GUYS." THEY COME FROM ALL WALKS OF LIFE, FROM ALL OVER THE NATION.

BUT THEY DO HAVE ONE THING IN COMMON: THEY ARE INVESTORS IN THE EQUITY CAPITAL MARKET. THEY ARE CAPITALISTS. IT IS OUR CAPITALISTIC SYSTEM CALLED FREE ENTERPRISE OR PEOPLE'S CAPITALISM THAT HAS PROVIDED A MECHANISM FOR ITS PEOPLE TO BUILD OUT OF A WILDERNESS THE GREATEST INDUSTRIALIZED COUNTRY IN THE WORLD. ANY INDIVIDUAL CAN INVEST IN AND OWN A SHARE OF MOST AMERICAN CORPORATIONS. HE OR SHE CAN BECOME PART OWNER WITH VOTING RIGHTS AND PARTICIPATE IN THE GROWTH OF THE ENTERPRISE AND THE COUNTRY.

THE SUCCESS AND STRENGTH OF THIS SYSTEM COME FROM THIS LARGE DIVERSIFIED OWNERSHIP BASE OF STOCKHOLDERS. THE INDIVIDUAL INVESTORS HAVE BEEN CALLED THE BACKBONE OF THE SYSTEM. FOR THE MILLIONS OF DIFFERING INDIVIDUAL DECISIONS MADE DAILY IN DIVERSIFIED MARKET TRANSACTIONS ARE NEEDED FOR LIQUIDITY, FOR A TRUE AUCTION, AND A MORE REALISTIC VALUE OF STOCKS. THIS IS VERY IMPORTANT. WHEN YOU CONSIDER THAT A LARGE PERCENTAGE OF THE ASSETS OF PENSION FUNDS, MUTUAL FUNDS, FUNDS OF INSURANCE COMPANIES, CHURCH FUNDS, AND SCHOOL FUNDS ARE INVESTED IN EQUITY SECURITIES, THE LIVES OF MOST AMERICANS ARE TOUCHED. ACTUALLY THEY ARE INDIRECT STOCKHOLDERS; THEREFORE, LIQUIDITY AND A REALISTIC VALUE OF STOCKS ARE OF GRAVE CONCERN TO ALL.

ALSO, THE INVESTING PATTERN OF THE INDIVIDUAL DIFFERS FROM THE PATTERN OF THE LARGE FINANCIAL INSTITUTIONS. FUND MANAGERS, EITHER BECAUSE OF REGULATIONS OR FIDUCIARY RESPONSIBILITIES,

INVEST PRIMARILY IN THE WELL-ESTABLISHED COMPANIES AND, FOR THE MOST PART, IN A FAVORED FEW. THE INDIVIDUAL IN HIS OWN FRAME OF INTEREST AND JUDGMENT USING HIS OWN CAPITAL MAY MAKE INVESTMENTS IN THE SMALL, OFTEN MORE VENTURESOME HIGH-RISK COMPANIES - PERHAPS EVEN NEW REGIONAL ONES WHICH MAY BECOME THE GENERAL MOTORS OR THE IBM'S OF THE FUTURE. FURTHER, IT IS THE SMALL AND MEDIUM SIZE GROWTH COMPANIES WHICH WOULD INCLUDE NEW TECHNOLOGIES AND DERIVATIVES OF NEW SCIENTIFIC RESEARCH WHERE THE NEEDED JOB OPPORTUNITIES ARE CREATED. WITHOUT NEW GROWTH THERE IS NO NEW WEALTH. THE IMPORTANCE OF EQUITY INVESTMENT TO COMPETITIVENESS IN THE WORLD MARKETS CANNOT BE EMPHSIZED TOO STRONGLY. THEREFORE, INCENTIVES TO ENCOURAGE AND STIMULATE INVESTMENT SHOULD BE OF PARAMOUNT CONCERN IN THE RESTRUCTURING OF OUR TAX CODE. WE SHOULD KEEP OR EXPAND TAX PROVISIONS WHICH HAVE PROVEN EFFECTIVE IN STIMULATING EQUITY INVESTMENT. WE HAVE RECENT HISTORIC PROOF OF THIS IN THE TREATMENT OF CAPITAL GAINS.

WHEN CONGRESS PASSED THE REVENUE ACT OF 1978, WHICH REDUCED TAXES ON CAPITAL GAINS FOR BOTH INDIVIDUALS AND CORPORATIONS, OUR CAPITAL MARKETS SHOWED MARKED IMPROVEMENT. NEW CAPITAL RAISED THROUGH INITIAL PUBLIC STOCK OFFERINGS WAS \$2.5 BILLION MORE FOR 1978-79 THAN FOR 1976-77. THIS AMOUNT OF MONEY HAS THE POTENTIAL TO CREATE 160,000 NEW JOBS. INVESTORS RETURNED TO THE MARKET, (TREASURY REVENUE

FROM CAPITAL GAINS INCREASED \$1.8 BILLION AFTER 1979.) AFTER THE CAPITAL GAINS TAX CUT TOOK EFFECT ON JANUARY 1, 1979, 130,000 NEW INVESTORS ENTERED THE STOCK MARKET IN AN AVERAGE MONTH, COMPARED WITH THE PREVIOUS MONTHLY FIGURE OF 86,000. THE TOTAL NUMBER OF STOCKHOLDERS INCREASED TO 29 MILLION FROM A LOW OF 25 MILLION IN 1975.

AFTER THE TAX ON CAPITAL GAINS WAS REDUCED FURTHER IN 1981 TO THE CURRENT 20 PERCENT, OVER \$4 BILLION IN NEW CAPITAL WAS RAISED THROUGH NEW STOCK OFFERINGS - NEW ISSUES, AND IN 1983 OVER \$12 BILLION WAS RAISED. LAST YEAR - 1984 - THE FIGURE WAS \$3.9 BILLION (NYSE STATISTIC). THE NUMBER OF STOCKHOLDERS INCREASED TO THE CURRENT 42.4 MILLION. IT IS INTERESTING TO NOTE THAT IN 1975 THE MEDIAN AGE OF STOCKHOLDERS WAS 53. NOW THE MEDIAN AGE IS 44.

THIS, OF COURSE, IS GOOD AND A STEP IN THE RIGHT DIRECTION. OUR CAPITALISTIC SYSTEM DEPENDS ON A CONTINUING SUPPLY OF NEW PRIVATE CAPITAL EVERY YEAR. CAPITAL IS THE FUNDAMENTAL FOUNDATION OF ALL GOODS AND SERVICES. ANY TAX ON CAPITAL IS INDICATIVE OF A MISCONCEPTION OF ITS VITAL FUNCTION IN A FREE ENTERPRISE SYSTEM; THEREFORE, TO DEDUCT FROM IT ANNUALLY IN THE FORM OF TAXATION IS TO DIMINISH OUR NATIONAL PRODUCTIVITY BASE. WHILE THE LOWERING OF THE TAX ON CAPITAL GAINS IS APPEALING AND WELCOME, REALLY THERE SHOULD BE NO TAX ON CAPITAL GAINS. TO CONFIRM THIS POINT SOME OF OUR INTERNATIONAL COMPETITORS HAVE NEVER TAXED CAPITAL GAINS AT ALL; OTHERS ONLY NOMINALLY.

ANOTHER PROVISION WHICH HAS PROVEN EFFECTIVE IN STIMULATING EQUITY INVESTMENT IS THE DIVIDEND REINVESTMENT PLAN. WHILE THIS TAX DEFERRAL PROVISION FOR DIVIDENDS REINVESTED IS NOT INCLUDED AS ONE OF THE PRESIDENT'S TAX PROPOSALS, THE CURRENT DIVIDEND REINVESTMENT LEGISLATION EXPIRES AT THE END OF THIS YEAR. RECOGNIZING THIS, REPRESENTATIVE PICKLE AND REPRESENTATIVE FRENZEL, MEMBERS OF THE HOUSE WAYS AND MEANS COMMITTEE, HAVE INTRODUCED A BILL - H.R. 654 - WHICH COULD BECOME A PART OF THE TAX REFORM LEGISLATION. THIS BILL IS IDENTICAL TO S. 1543 INTRODUCED BY SENATOR BENTSEN AND SENATOR BAUCUS IN THE 96TH CONGRESS. THE CURRENT LEGISLATION HAS A CAP OF \$750 TAX DEFERRAL FOR SINGLE PERSONS AND \$1,500 FOR A JOINT RETURN AND APPLIES ONLY TO UTILITY COMPANIES. IT IS ESTIMATED THAT \$4 BILLION A YEAR WAS REINVESTED IN QUALIFYING PLANS WITH 3 MILLION STOCKHOLDERS PARTICIPATING. A LARGE MAJORITY OF THESE PARTICIPANTS ARE SMALL STOCKHOLDERS, AND THEY OWN FROM 1 TO 300 SHARES. H.R. 654 WOULD RAISE THE CAP TO \$1,500/3,000 AND APPLY NOT ONLY TO UTILITIES BUT NON-UTILITY CORPORATIONS AS WELL.

THE TECHNIQUE REMAINS THE SAME. DIVIDENDS REINVESTED IN ORIGINAL ISSUE STOCK UNDER A QUALIFIED DIVIDEND REINVESTMENT PLAN WOULD BE EXEMPT FROM THE STOCKHOLDER'S FEDERAL INCOME TAX. STOCK MUST BE KEPT A YEAR. STOCKS PURCHASED IN THIS MANNER WOULD BE TREATED SIMILARLY TO STOCK DIVIDENDS AND SUBJECT

TO CAPITAL GAINS WHEN SOLD. COMPANIES NEED TO GENERATE EQUITY CAPITAL INTERNALLY RATHER THAN BORROW IN THE CAPITAL MARKETS AT HIGH INTEREST RATES. THERE HAS BEEN A DANGEROUS INCREASE IN DEBT/EQUITY IN RECENT YEARS. CLIMBING DEBT RATIOS MAKE BUSINESS HIGHLY VULNERABLE TO BUSINESS CYCLE CHANGES. THE GROWTH OF HIGH DEBT RATIOS IS UNDESIRABLE AND TENDS TO CAUSE BANKRUPTCIES, GENERALLY SUPPRESS ECONOMIC GROWTH AND STYMIES THE ABILITY OF BUSINESS TO EXPAND AND MODERNIZE. BOTH COMPANIES AND STOCKHOLDERS ARE WINNERS WITH REINVESTED DIVIDENDS. THE STOCKHOLDER INCREASES HIS OR HER INVESTMENT AND THE COMPANY HAS MORE WORKING CAPITAL. CAPITAL IS THE FUEL THAT KEEPS OUR GREAT AMERICAN BUSINESS MACHINE RUNNING.

THE ROLE OF STOCKHOLDERS IS UNIQUE. ACTUALLY, THEY ARE THE ALLIES OF CORPORATE MANAGEMENT. STOCKHOLDERS ARE PRO-BUSINESS; THEY ARE ENTREPRENEURS; THEY RUN THEIR OWN BUSINESS (THEIR PORTFOLIOS). IF THE COMPANY PROSPERS, STOCKHOLDERS - THE OWNERS - PROSPER; IF IT DOESN'T, NEITHER DO THEY. THEREFORE, TAX PROVISIONS FOR BUSINESS ARE OF CONCERN TO STOCKHOLDERS AS WELL.

IT WOULD BE IMPOSSIBLE TO ADDRESS ALL THE PROVISIONS IN THIS WELL-THOUGHT OUT TAX PACKAGE. WE ARE IMPELLED, HOWEVER, TO ADDRESS THE SUBJECT OF DOUBLE TAXATION ON DIVIDENDS. IN ALL OUR SURVEYS OF STOCKHOLDER OPINION, THE NUMBER ONE SORE POINT IS THE UNFAIRNESS OF THE TAXATION ON DIVIDENDS. IT WAS ALMOST A UNANIMOUS FEELING THAT STOCKHOLDERS SHOULD

RECEIVE TAX CREDIT FOR THE TAXES ALREADY PAID BY THE CORPORATION. THIS HAS NOT BEEN DONE. NOW IN THE TAX PLAN UNDER CONSIDERATION, THE PRINCIPLE OF DOUBLE TAXATION HAS BEEN ADDRESSED. A CORPORATION WOULD BE ALLOWED A DEDUCTION EQUAL TO 10 PERCENT OF THE DIVIDENDS PAID TO THEIR STOCKHOLDERS. THE DIVIDEND DEDUCTION WOULD BE TREATED THE SAME AS OTHER BUSINESS DEDUCTIONS. UNDOUBTEDLY, IF THE PRINCIPLE IS BEING ESTABLISHED, THE 10 PERCENT FIGURE COULD BE CONSTRUED AS THE FIRST STEP TOWARD THE ELIMINATION OF DOUBLE TAXATION.

IN FAIRNESS WE PROPOSE THAT THE STOCKHOLDERS ALSO BE ALLOWED A 10 PERCENT TAX CREDIT TO COMPENSATE FOR THE TAX ALREADY PAID BY THE CORPORATION. THE TAX CREDIT FOR THE STOCKHOLDERS WOULD MATCH THE DEDUCTION ALLOWED THE CORPORATION.

A COMBINATION OF DIVIDEND DEDUCTIONS AND STOCKHOLDER CREDITS IS NOT A NEW IDEA. THIS PLAN WAS A TREASURY DEPARTMENT RECOMMENDATION IN 1975 WHEN WILLIAM SIMON WAS TREASURY SECRETARY. THE CREDIT MECHANISM IS SIMPLE. THE TAXPAYER WOULD "GROSS UP" THE DIVIDEND BY ADDING TO HIS TAXABLE INCOME AN AMOUNT EQUAL TO 10 PERCENT OF THE DIVIDENDS AND WOULD THEN TAKE A TAX CREDIT EQUAL TO THE "GROSS UP." VIRTUALLY ALL OF OUR MAJOR TRADING PARTNERS HAVE A SYSTEM WHICH ELIMINATES MUCH OF THE DOUBLE TAX.

WE RECOGNIZE THE COMMITTEE IS WORKING TOWARD KEEPING THE FINAL LEGISLATION "REVENUE NEUTRAL," AS THE PRESIDENT PROPOSED,

BUT REPEALING OR REDUCING INVESTMENT INCENTIVES WOULD NOT ACCOMPLISH THE DESIRED RESULTS. WE SHOULD BE INCREASING INVESTMENT INCENTIVES. WE MUST HAVE A CONTINUOUS CONSTANT FLOW OF NEW INVESTMENT CAPITAL INTO THE MARKET FOR PROSPEROUS GROWTH.

PEOPLE INVEST TO MAKE MONEY. IF YOU TAKE AWAY INCENTIVES, THEY WON'T INVEST. GENTLEMEN, IT'S AS SIMPLE AS THAT.

AGAIN, THANK YOU.

* * * * *

